

## Amended Sec Rule 15c2-12: An Attempt to Improve Disclosure Practices in the Municipal Securities Market

Christine A. Scheel

Follow this and additional works at: <https://via.library.depaul.edu/law-review>

---

### Recommended Citation

Christine A. Scheel, *Amended Sec Rule 15c2-12: An Attempt to Improve Disclosure Practices in the Municipal Securities Market*, 45 DePaul L. Rev. 1117 (1996)  
Available at: <https://via.library.depaul.edu/law-review/vol45/iss4/9>

This Comments is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Law Review by an authorized editor of Via Sapientiae. For more information, please contact [digitalservices@depaul.edu](mailto:digitalservices@depaul.edu).

# **AMENDED SEC RULE 15C2-12: AN ATTEMPT TO IMPROVE DISCLOSURE PRACTICES IN THE MUNICIPAL SECURITIES MARKET**

## TABLE OF CONTENTS

|   |      |
|---|------|
| INTRODUCTION .....  | 1118 |
| I. MUNICIPAL FINANCING STRUCTURES .....   | 1122 |
| A. <i>Derivative Products</i> .....   | 1123 |
| B. <i>Credit Enhancements</i> .....   | 1124 |
| II. MUNICIPAL MARKET PARTICIPANTS .....   | 1127 |
| A. <i>The Issuer</i> .....  | 1128 |
| B. <i>Underwriters</i> .....  | 1128 |
| C. <i>Financial Advisors</i> .....  | 1129 |
| D. <i>Trustees and Legal Counsel</i> .....  | 1130 |
| III. CURRENT REGULATION OF THE MUNICIPAL SECURITIES<br>MARKET .....   | 1130 |
| A. <i>The Federal Antifraud Provisions</i> .....  | 1131 |
| B. <i>State Blue Sky Laws</i> .....   | 1135 |
| C. <i>Industry Practice and Voluntary Guidelines</i> .....  | 1136 |
| D. <i>Government Regulation of Market Participants</i> .....  | 1137 |
| IV. REGULATION OF THE MUNICIPAL SECURITIES MARKET<br>UNDER AMENDED RULE 15c2-12 .....                             | 1141 |
| A. <i>The Problems with Current Municipal Disclosure<br/>            Practices</i> .....                          | 1142 |
| B. <i>Amended Rule 15c2-12</i> .....  | 1144 |
| V. ANALYSIS OF AMENDED RULE 15c2-12 .....   | 1158 |
| A. <i>The SEC's Authority to Enforce the Amended Rule is<br/>            Questionable</i> .....                   | 1158 |
| B. <i>The Amended Rule Fails to Adequately Address the<br/>            Problems in the Municipal Market</i> ..... | 1161 |
| CONCLUSION .....  | 1164 |

## INTRODUCTION

The Securities Act of 1933 (Securities Act or 1933 Act)<sup>1</sup> and the Securities Exchange Act of 1934 (Exchange Act or 1934 Act)<sup>2</sup> contain broad exemptions for municipal securities.<sup>3</sup> In particular, Congress accorded municipal securities special exemptions from the registration and civil liability provisions of the Securities Act and the periodic reporting requirements of the Exchange Act.<sup>4</sup> Congress predicated these exemptions on the widely held belief that, unlike the corporate debt market, to which the federal securities laws fully apply, the municipal market was not as susceptible to manipulation and abuse.<sup>5</sup> In

1. 15 U.S.C. § 77a-z (1994).

2. 15 U.S.C. § 78a-ll (1994).

3. Section 3 (a)(29) of the Securities Exchange Act of 1934 defines "municipal securities" as securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a state or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond . . . the interest on which is excludable from gross income [under the Internal Revenue Code] . . . .

*Id.* § 78c(29).

4. Municipal securities are, however, subject to the antifraud provisions of Section 17q(a) of the Securities Act, *Id.* § 77q(a), Section 10(b) of the Exchange Act, *Id.* § 78, and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1995), promulgated under Exchange Act Section 10(b). Accordingly, municipal issuers generally focus on providing investors with an accurate and complete description of the offered securities and the credit source supporting those securities. Paul S. Maco, *Municipal Securities Law Under Rule 15c2-12: Compliance, Requirements and Developments* (PLI Real Estate Law and Practice Course Handbook Series No. N4-4579, 1993). For further discussion of the federal antifraud provisions, see *infra* part III.A.

5. Municipal Securities Disclosure, Securities Exchange Act Release No. 34,961, [1994-1995 Transfer Binder, Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,951 n.1 (Nov. 10, 1994) [hereinafter Release No. 34,961]. Exchange Act Section 3(a)(12) defines "exempted security" or "exempted securities" as

[Government] securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; . . . securities which are issued or guaranteed by corporations in which the United States has a direct or indirect interest and which are . . . necessary or appropriate in the public interest or for the protection of investors; [or] municipal securities as defined in section 3(a)(29) . . . . 15 U.S.C. § 78c(a)(12). Section 3(a)(2) of the Securities Act contains a similar exemption. 15 U.S.C. § 77c(a)(2). For the definition of "municipal securities" under Securities Exchange Act § 3(a)(29), see *supra* note 3.

Although basic municipal securities are exempt from the federal securities laws' registration and reporting requirements, more complex municipal issues, e.g., those involving credit enhancements, may constitute separate "securities," which must be registered under the Securities Act of 1933. AMERICAN BAR ASSOCIATION, SECTION OF URBAN, STATE, AND LOCAL GOVERNMENT LAW, DISCLOSURE ROLES OF COUNSEL IN STATE AND LOCAL GOVERNMENT SECURITIES OFFERINGS 100 (2d ed. 1994) [hereinafter DISCLOSURE ROLES OF COUNSEL]. Securities Exchange Act Section 3(a)(10) defines "security" as "any note, . . . bond, . . . evidence of indebtedness, . . . or, in general, any [interest or] instrument commonly known as a "security"; or any . . . guarantee of . . . any of the foregoing." 15 U.S.C. § 78c(a)(10). In addition, the definition of "sale"

addition, market regulators generally have regarded municipal bond investors, largely institutional investors such as insurance companies and mutual funds, as more sophisticated than individual investors, who preferred corporate debt instruments.<sup>6</sup> Besides institutional investors, wealthy individuals, through the advice of market analysts, traditionally purchased municipal bonds as low risk tax shelters.<sup>7</sup> In the past, municipal securities appealed to individuals in higher tax brackets because the federal tax laws, and in certain instances state tax laws and local tax ordinances, exempted the interest received by holders of most municipal securities from taxable income.<sup>8</sup>

Changes to federal income tax laws have now made municipal securities increasingly attractive to middle income investors.<sup>9</sup> Today, average income households constitute the largest holders of municipal debt, "followed by municipal bond funds, property and casualty insurers, commercial banks, and money market funds."<sup>10</sup> As municipal securities investors have become less sophisticated, the municipal market has become increasingly risky.<sup>11</sup> A recent illustration of the heightened risk of municipal securities is the Orange County debacle. On November 17, 1994, Orange County, California sustained huge losses in a seven and one-half billion dollar investment pool it ran for itself and 180 other municipalities, which caused the largest municipal bankruptcy in history.<sup>12</sup>

---

in the 1933 Act effectively provides that any security given or delivered with any purchase of securities is conclusively presumed to be part of the securities purchased and to have been offered and sold for value. *Id.* § 77b(3); DISCLOSURE ROLES OF COUNSEL, *supra* at 100 n.258. Collectively, the foregoing definitions suggest that all direct credit enhancements constitute "securities" if they functionally guarantee the payment of other securities. *Id.* at 100. For a general discussion of direct credit enhancements, see *infra* part I.B.1.

6. *A Bill to Amend the Federal Trade Commission Act to Extend the Authorization of Appropriations in Such Act: Hearings on H.R. 2243 Before the Subcommittee on Transportation and Hazardous Materials of the Committee of Energy and Commerce*, 103rd Cong., 1st Sess. 10, 13-14, 72 (1993) (Staff Report on the Municipal Securities Market, Division of Market Regulation, SEC) [hereinafter Staff Report].

7. *Id.* at 13-14.

8. *Id.* at 14.

9. *Id.* Besides modifications to federal income tax structures, the introduction of \$5,000 denomination municipal bonds and municipal bond mutual funds have made municipal securities more affordable for individual investors. Maco, *supra* note 3.

10. Staff Report, *supra* note 6, at 14. In 1983, institutional investors held roughly 44 percent of outstanding municipal debt, as compared with 76 percent in 1993. Release No. 34,961, *supra* note 5, at 85,952 n.6.

11. Staff Report, *supra* note 6, at 14.

12. Craig Stock, *A Goofy Investment Strategy; Understanding What Caused Orange County's Financial Disaster*, CHI. TRIB., Dec. 23, 1994, at C13. To increase the interest income generated by the money in the investment pool, Orange County Treasurer Robert L. Citron employed an investment strategy called the "carry trade," which involved borrowing short-term, lower-rate

These conditions—the relative lack of sophistication of today's municipal securities investors and increased market risk—place greater responsibility on broker-dealers to investigate municipal issues and disclose the risks of such investments.<sup>13</sup> Despite the heightened need for better disclosure in the contemporary municipal market, no prescribed format exists for municipal disclosure documents.<sup>14</sup> This lack of guidance has resulted in erratic municipal market disclosure. For example, most municipal disclosure documents consist merely of the issuer's official statement.<sup>15</sup> Moreover, the form and content of these official statements vary, depending on the issuer's size and borrowing frequency.<sup>16</sup>

Although the current federal regulatory structure precludes the Securities and Exchange Commission (SEC or Commission) from controlling municipal issuers, the SEC indirectly regulates the timing and production of official statements through the provisions of Rule 15c2-12,<sup>17</sup> which was promulgated in 1989 under Section 15(c)(2) of the 1934 Act.<sup>18</sup> Rule 15c2-12 requires brokers,<sup>19</sup> dealers,<sup>20</sup> and municipal

---

money and using it to invest in, or "carry," longer-term securities paying higher interest rates. *Id.* In October 1993, when interest rates started to rise, borrowing costs sharply increased and the market value of long-term securities fell. *Id.* Accordingly, the "spread" between lending and borrowing costs decreased and the investment pool became less profitable. *Id.* As of December 23, 1994, experts estimated the resulting losses to be at least \$2.02 billion. Nell Henderson, *Orange County Puts on the Squeeze; \$ 40 Million in Cuts Ordered in Area Unfamiliar With Economic Contraction*, WASH. POST, December 23, 1994, at A4. In the wake of the Orange County bankruptcy, municipalities nationwide face higher borrowing costs. David J. Lynch, *Orange County; How It Happened; How Golden Touch Turned Into Crisis*, USA TODAY, December 23, 1994, at B1.

13. Staff Report, *supra* note 6, at 14.

14. Maco, *supra* note 3. In contrast to the informal disclosure practices that dominate the municipal market, corporate issuers have extensive disclosure obligations that derive from the federal securities laws' registration and periodic reporting provisions. Ann J. Gellis, *Mandatory Disclosure for Municipal Securities: Issues in Implementation*, 13 J. CORP. L. 65, 105-06 (1987). Like municipal issuers, corporate issuers must also comply with the federal antifraud provisions. *Id.* at 74.

15. Maco, *supra* note 3. In a public offering of municipal bonds, the basic disclosure document is the official statement. *Id.* A typical official statement contains a description of the issuer, the bonds, any security and sources of payment, the project or purpose of the borrowing, the sources and uses of funds for the project, the borrower, risk factors, and a summary of legal issues, tax exemption matters and underwriting costs. *Id.* The borrower's audited financial statements and a feasibility study or revenue forecast are often appended to the official statement. *Id.*

16. Staff Report, *supra* note 6, at 38.

17. 17 C.F.R. § 240.15c2-12 (1994).

18. 15 U.S.C. § 78o(c)(2). Section 15(c)(2) mandates that

no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in connection with which such

securities dealers<sup>21</sup> that underwrite municipal securities offerings to review the issuer's official statement and distribute copies of it to investors.<sup>22</sup> Under this rule, the Commission has also published three sets of interpretive guidelines explaining the disclosure responsibilities of underwriters, dealers, and issuers under the federal antifraud provisions.<sup>23</sup>

Attempting to improve the quantity and quality of municipal market information, the SEC amended Rule 15c2-12 in late 1994 to prohibit underwriters from purchasing or selling municipal securities in a primary offering—the original sale of securities—without first determining that the issuer has provided adequate disclosure in its official statement and has contracted to provide secondary market—the market in which securities are traded after their original issuance—disclosure commensurate with that contained in its official statement.<sup>24</sup> The amended rule further requires dealers engaging in secondary municipal market transactions to implement systems that allow them to receive current market information regarding the securities that they recommend.<sup>25</sup> Amended Rule 15c2-12 became fully effective on January 1, 1996.<sup>26</sup>

---

municipal securities dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation.

*Id.* This section further provides that the SEC “shall, . . . by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.” *Id.*

19. Section 3(a)(4) of the Securities Exchange Act states that “[t]he term ‘broker’ means any person engaged in the business of effecting transactions in securities for the account of others.” *Id.* § 78c(a)(4).

20. Under the Securities Exchange Act, the term “dealer” refers to “any person engaged in the business of buying and selling securities for his own account, . . . or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.” *Id.* § 78c(a)(5).

21. The Securities Exchange Act defines “municipal securities dealer” to include “any person . . . engaged in the business of buying and selling municipal securities for his own account.” *Id.* § 78c(a)(30).

22. See Maco, *supra* note 3 (discussing the impact of Rule 15c2-12, as enacted in 1989, on municipal market participants).

23. Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Exchange Act Release No. 33,741, 59 Fed. Reg. 12,748 (Mar. 9, 1994) [hereinafter Release No. 33,741]; Municipal Securities Disclosure, Securities Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799 (June 28, 1989) [hereinafter Release No. 26,985]; Municipal Securities Disclosure, Securities Exchange Act Release No. 26,100, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 25,097 (Sept. 22, 1988) [hereinafter Release No. 26,100].

24. Release No. 34,961, *supra* note 5, at 85,951.

25. *Id.*

26. *Id.* at 85,950-51.

This Article analyzes whether the 1996 amendments to Rule 15c2-12 will successfully improve municipal market disclosure.<sup>27</sup> The Article begins in Part I by examining a variety of municipal financing structures. Part II discusses the major participants in the municipal securities market. Part III provides an overview of the municipal market prior to the enactment of amended Rule 15c2-12. Part IV looks at municipal market regulation under the amended Rule. This Section begins by discussing the problems with traditional municipal disclosure practices and then compares the requirements of Rule 15c2-12 as originally enacted with those under the amended rule. Finally, Part IV analyzes amended Rule 15c2-12. The first part of the Analysis examines whether the SEC has the authority to enforce the new provisions of Rule 15c2-12. The Analysis then evaluates whether amended Rule 15c2-12 successfully addresses the inadequacies of conventional municipal disclosure practices in the primary and secondary markets. This Article concludes that the Commission's authority to enforce amended Rule 15c2-12 is questionable, and that the Rule will fail to provide uniform primary market disclosure, which will result in inadequate guidance to municipal market participants regarding the proper form and content of periodic disclosure to the secondary market.

### I. MUNICIPAL FINANCING STRUCTURES

All bonds essentially involve an issuer's promise to repay investors the borrowed amount plus interest over a specified time period.<sup>28</sup> General obligation bonds are the quintessential form of municipal financing.<sup>29</sup> In the 1990s, however, most municipal offerings employ revenue bonds, which present greater risks to investors.<sup>30</sup> Aside from

---

27. The municipal securities market is comprised of about 50,000 state and local issuers with outstanding principal in excess of one-point-two trillion dollars. Staff Report, *supra* note 6, at 13. "Approximately 2,600 dealers, banks and brokers actively trade in municipal securities." *Id.* Furthermore, in 1992, "12,709 new issues of municipal securities took place, with an [aggregate] value of \$235 billion." *Id.* Daily trading volume in the secondary municipal market is approximately three million dollars. *Id.* at 57 n.18.

28. FRANK D. FABOZZI & T. DESSA FABOZZI, *BOND MARKETS, ANALYSIS AND STRATEGIES* 1 (1989).

29. Staff Report, *supra* note 6, at 14. General obligation bonds promise repayment of principal on a definite future date and periodic interest payments at a specified rate. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 25. The issuer's full faith and credit and general taxing power secure repayment of general obligation bonds. *Id.* Therefore, municipal general obligation bonds were conventionally perceived as a very safe investment because investors could look to all of the municipality's revenue sources for repayment. Staff Report, *supra* note 6, at 13.

30. Staff Report, *supra* note 6, at 14. Revenue bonds alter the general obligation bond structure by limiting the municipality's payment obligation to funds generated from a specific source such as user fees, special taxes, or revenue earned by a particular enterprise. *Id.* at 13-14. For example, a municipality may issue revenue bonds to finance a resource recovery facility designed

the move away from the general obligation bond, municipalities now favor conduit financing arrangements,<sup>31</sup> such as industrial development bonds,<sup>32</sup> the proceeds of which are used to fund a project used in the trade or business of a private corporation.<sup>33</sup> Derivative products and credit enhancements have further complicated the municipal securities market.

### A. Derivative Products

The recent introduction of derivative products in the municipal market greatly expanded the financing options available to municipal issuers.<sup>34</sup> Derivatives result either from the combination or division of other securities.<sup>35</sup> For example, a derivative security may consist of a series of contractual relationships, each of which comprises an independent security, such as the combination of a floating rate security with an option to tender the security.<sup>36</sup> Alternatively, a derivative may arise by separating a security into distinct components, such as the "stripping" of interest payment rights.<sup>37</sup> Ideally, derivative products benefit both governmental issuers and municipal investors by reducing borrowing costs, while creating securities that meet the

---

to process solid waste, use such waste to produce and sell electricity, and allocate the revenue derived from the facility's operation as the sole source of repayment. *Id.* at 55 n.8.

31. *Id.* at 13. Principal and interest payments on conduit bonds derive solely from revenues paid to the municipality by a private company—which is the actual obligor—pursuant to a contractual obligation, such as a note, long-term lease or installment sale agreement, rather than from the general credit and taxing power of the municipal issuer or from specific project revenues. *Id.* For example, a municipality could issue conduit bonds to finance a facility to be sold to a private business under an installment lease and use the rental income to pay the principal and interest on the bonds. *Id.* at 55 n.9. Thus, in conduit offerings, the governmental issuer does not pledge its taxing power for repayment of the borrowing and bondholders do not have any recourse against it, *id.*; the governmental issuer merely functions as a nominal obligor. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 8 n.17. Because the corporate borrower bears ultimate responsibility for repayment, conduit securities present investment risks analogous to those of corporate debt securities. See, e.g., Release No. 33,741, *supra* note 24, at 12,752 ("The private nature of many conduit enterprises distinguishes them from tradition municipal financings.").

32. An industrial development bond consists of

any obligation which is issued as part of an issue all or a major part of which are to be used directly or indirectly in any trade or business carried on by any person who is not [exempt from federal income taxation] . . . and the payment of the principal or interest on which . . . is directly or indirectly, in whole or in major part secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or . . . a mortgage subsidy bond . . . , or to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

I.R.C. § 103(b)(2).

33. Staff Report, *supra* note 6, at 13.

34. *Id.*

35. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 26.

36. *Id.*

37. *Id.*



perceived needs of particular types of municipal investors.<sup>38</sup> Examples of municipal derivatives include principal and interest strips,<sup>39</sup> detachable call options,<sup>40</sup> and complex variable rate securities.<sup>41</sup>

### B. Credit Enhancements

Under certain circumstances, an issuer may improve the marketability or pricing of its offering by using a credit enhancement, which provides an additional source of payment for the debt.<sup>42</sup> Credit enhancements are classified as either direct or indirect, depending on the nature of the contract involved.<sup>43</sup> Direct credit enhancements include bond insurance, direct-pay and standby letters of credit, bond purchase agreements, and guarantees; indirect credit enhancements include take-or-pay contracts, investment agreements, and lines of credit.

#### 1. Direct Credit Enhancements

Although direct credit enhancements take various forms, all involve a direct contractual obligation between the issuer and the securities' owners.<sup>44</sup> The most prevalent form of direct credit enhancement is municipal bond insurance.<sup>45</sup> Under a bond insurance contract, the issuer agrees to pay the investors' trustee or paying agent sufficient funds to secure payment of principal and interest on the securities.<sup>46</sup>

---

38. Staff Report, *supra* note 6, at 13.

39. *Id.* Principal and interest strips involve a trust arrangement that divides municipal securities into as many as two dozen principal and interest income components. *Id.* at 56 n.11.

40. Detachable call options are created by dividing a callable bond into two securities: the underlying debt security and the option to call the bond. *Id.* at 56 n.12. The issuer of detachable call option bonds may retain the separate tender option or sell it to investors in the bond's initial public offering or at some later time. *Id.* Once the issuer sells the option, independent investors having no interest in the underlying municipal debt may freely trade the option on the secondary municipal market. *Id.* Dealers generally sell detachable call options to institutional investors, who employ such options as a hedge against declining interest rates. *Id.*

41. Complex "variable rate securities include inverse floating rate securities and securities with imbedded swaps." *Id.* at 56 n.13. These securities allow a municipal issuer to pay a fixed rate at a reduced interest cost while offering investors a floating rate. *Id.* Complex variable rate securities may consist of a trust agreement, which redirects interest and principal flows between bondholders. *Id.* These securities are also formed "through swap arrangements with investment banks where the issuer's fixed rate is swapped for the floating rate, which is passed on to issuers." *Id.*

42. *Id.* at 26. "Over 37 percent of the dollar volume of new long term issues carry some form of credit enhancement." Release No. 33,741 *supra* note 23, at 12,752 (citing Public Securities Association, MUNICIPAL MARKET DEVELOPMENTS, Aug. 1993, at 5.

43. For a complete examination of the numerous direct and indirect credit enhancements available to municipal issuers, see DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 32-38.

44. *Id.* at 32.

45. *Id.*

46. *Id.*

The bond insurer usually contracts to indemnify the investor for "issuer payments that are or become voidable as preferential transfers under the federal Bankruptcy Code."<sup>47</sup> Generally, bond insurance does not cover accelerated payments of principal upon redemption or default, nor does it insure the payment of redemption premiums, unless the insurer provides such coverage in a special endorsement to the policy.<sup>48</sup> A second type of direct credit enhancement is a letter of credit.<sup>49</sup> Letters of credit consist of contractual obligations to pay up to a specified amount of principal and interest on demand to a trustee for the benefit of the securities' owners.<sup>50</sup> Letters of credit are classified as "direct pay" or "standby," depending on the types of documents that must be presented to draw on the letter.<sup>51</sup>

In addition to bond insurance and letters of credit, bond purchase agreements function as a type of credit enhancement. A bond purchase agreement is a contractual commitment by the issuing bank in favor of a trustee representing the securities' owners to purchase tender option securities that the issuer is unable to remarket.<sup>52</sup> Unlike bond insurance or letters of credit, bond purchase agreements do not guarantee payment of principal and interest.<sup>53</sup> For that reason, the viability of both the bond purchase agreement and the underlying tender option securities depends upon the financial performance of both the issuer and the purchase agreement provider.<sup>54</sup>

---

47. *Id.* A form of direct credit enhancement related to bond insurance that is gaining acceptance among issuers is a bond indenture provision that purports to delegate to the insurer the ability to modify the indenture's terms prior to default without the bondholder's knowledge or consent. Release No. 33,741 *supra* note 23, at 12,752.

48. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 32-33.

49. *Id.* at 33.

50. *Id.*

51. *Id.* Direct-pay letters of credit allow the trustee to draw on the letter and to apply the proceeds to pay the amounts immediately due on the securities, and the funds advanced by the issuer or conduit borrower are applied to reimburse those draws. *Id.* By comparison, standby letters of credit provide for payment solely upon presentation of a certificate of default or insufficient funds for payment. *Id.* That is, the trustee may draw on a standby letter of credit only after the issuer or conduit borrower defaults in its primary payment obligation or the bondholders' payment rights are subordinated in a bankruptcy proceeding. *Id.*

52. *Id.* at 35.

53. *Id.* A municipal issuer ordinarily enters into a bond purchase agreement when payment of principal and interest on the securities is supported by bond insurance or when the issuer knows it has adequate credit to meet its principal and interest payments, but possesses insufficient liquidity to assure the repurchase of tendered securities on short notice. *Id.* For example, when bond insurance also supports payment of principal and interest, the bond purchase agreement often provides for cancellation of the tender option upon the termination of the purchase agreement, thereby converting short-term securities into long-term securities. *Id.*

54. *Id.*

Finally, entities related to the governmental issuer or conduit borrower occasionally offer guarantees to investors that assure full payment of principal and interest on the securities in the event that the issuer is unable to fulfill its repayment obligation.<sup>55</sup> Guarantees supplement the protection of municipal bond insurance, letters of credit, and bond purchase agreements.<sup>56</sup> For example, where a conduit issuer finances an asset purchase for the operating subsidiary of a more creditworthy corporate parent, the parent company frequently guarantees the securities to improve the securities' credit rating, thereby decreasing the issuer's interest expense.<sup>57</sup> Likewise, "some states have developed programs under which the state, or a state agency, guarantees the payment of securities issued by local government authorities."<sup>58</sup>

## 2. *Indirect Credit Enhancements*

Unlike direct credit enhancements, in which the issuer enters into privity of contract with the securities' holders, indirect credit enhancements involve a contractual relationship between the issuer and some third party for the benefit of the securities' holders.<sup>59</sup> Consequently, the securities repayment depends entirely on the performance or credit of the third party contractor.<sup>60</sup> Indirect credit enhancements include take or pay contracts, bond pools, investment agreements, and lines of credit.<sup>61</sup>

One type of indirect credit enhancement is the take-or-pay contract.<sup>62</sup> In a take-or-pay contract, a third party agrees to purchase a project's products or services regardless of whether these products or services are actually received.<sup>63</sup> Bond pools also function as a form of indirect credit enhancement.<sup>64</sup> A bond pool arises where a state or county issues securities to raise money for loans to local governments,

---

55. *Id.* at 35-36.

56. *Id.* at 35.

57. *Id.*

58. *Id.* at 35-36. These state-based guarantors "normally do not have the right [upon default] to accelerate, or to prevent acceleration of," the securities' maturity. *Id.* at 36. In contrast, where a federal agency guarantees the issue of a state, the federal guarantor's rights more closely resemble the rights of bond insurers. *Id.* For a discussion of municipal bond insurance, see *supra* notes 47-50 and accompanying text.

59. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 36.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.* The Orange County municipal bankruptcy involved a bond pool. See *supra* note 12 (summarizing the events surrounding the Orange County bond pool defaults).

which use the borrowed money to finance public improvements or to facilitate private economic development.<sup>65</sup> If the state or county pledges its own credit to guarantee repayment of the securities issued by the bond pool, the governmental guarantee indirectly improves the safety of the issue.<sup>66</sup>

Investment agreements represent a third kind of indirect credit enhancement.<sup>67</sup> For instance, securities issued to finance water improvement and distribution plants and waste or electric disposal facilities typically utilize investment agreements.<sup>68</sup> Finally, a line of credit can be an indirect credit enhancement. For example, an issuer or conduit borrower that is able to make principal and interest payments on an offering of variable rate tender option securities, but lacks the liquidity to repurchase any securities tendered for early redemption on short notice, might secure a line of credit.<sup>69</sup> Such an arrangement would allow the issuer or conduit borrower to obtain the necessary funds to repurchase any tendered securities that the issuer is incapable of remarketing.<sup>70</sup>

## II. MUNICIPAL MARKET PARTICIPANTS

In addition to selecting a financing structure for its securities, a municipal issuer must prepare an official statement that discloses certain information about the securities to potential investors.<sup>71</sup> Primary offerings of municipal securities involve several participants, each of whom carries specific obligations related to the information disclosed in the official statement.<sup>72</sup> The major players include the issuer, the conduit borrower, the credit enhancement provider, the underwriter, the financial advisor, the trustee, and legal counsel. A brief overview of the major players will help clarify their respective roles in municipal offerings.

---

65. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 36.

66. *Id.*

67. *Id.* at 37. Investment agreements usually take the form of guaranteed investment contracts, funding agreement contracts, insurance company annuities, deposit agreements with banks, or secured and unsecured investment agreements with banks or other financial institutions. *Id.*

68. *Id.* A municipal issuer might also use an investment agreement when it does not immediately need the proceeds of an issue. *Id.*

69. *Id.* A line of credit differs from a bond purchase agreement because with a line of credit the issuer, not the bank, repurchases the securities. See *supra* notes 53-55 (discussing bond purchase agreements).

70. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 37.

71. FABOZZI & FABOZZI, *supra* note 29, at 136.

72. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 7.

### A. *The Issuer*

The issuer is the central participant in a primary municipal securities offering.<sup>73</sup> Rule 15c2-12 defines an "issuer" of municipal securities to encompass both the governmental issuer and the issuer of any separate security, such as a conduit borrower or credit enhancement provider.<sup>74</sup> Thus, in many transactions, there will be more than one "issuer" for disclosure purposes.<sup>75</sup> A governmental entity, such as a state, state authority, city, county, or local limited function authority such as a water board, sewer authority, airport commission, or school district traditionally performed the role of governmental issuer.<sup>76</sup> In the modern municipal market, however, the governmental issuer more typically consists of a program issuer such as a student loan finance agency, a bond bank issuing securities for a group of governmental issuers, or a special finance district.<sup>77</sup>

### B. *Underwriters*

Underwriters also assume a predominant role in municipal transactions.<sup>78</sup> A group of underwriters, called an underwriting syndicate, usually acts together under the direction of a managing underwriter to promote and sell the offering.<sup>79</sup> Under Rule 15c2-12, the definition of "underwriter" includes any person who purchases municipal securities directly from an issuer with the intention of selling those securities,

---

73. *Id.* at 8.

74. *Id.* at 8 n.18. To illustrate, the issuer of a letter of credit is considered an "issuer" of municipal securities under Rule 15c2-12. Release No. 26,985 *supra* note 23, at 18,199 n.46.

75. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 8. The issuer's disclosure obligation varies with the function it serves in a given offering. *Id.* For example, in a general obligation issue, the governmental issuer functions as the primary obligor and controls most of the information subject to disclosure. *Id.* Therefore, it bears the most significant disclosure responsibilities. *Id.* In conduit offerings, however, the governmental issuer's disclosure obligation is generally limited to its identity, its role in the transaction and its authority to act in the transaction, while the conduit borrower bears the main disclosure responsibilities because it functions as the primary obligor. *Id.*

76. *Id.*

77. *Id.* In conduit transactions, the governmental issuer characteristically is a special public agency issuer, city or county, local or state industrial development board, health and educational facilities authority, dormitory authority or similar independent public entity. *Id.*

78. *Id.* at 9.

79. LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 37 (2d ed. 1990). The managing underwriter makes all of the arrangements with the issuer and establishes the underwriting syndicate. *Id.* The purposes of an underwriting syndicate include sharing the risks of underwriting the issue, obtaining sufficient capital to purchase the issue, and broadening the distribution of the issue to the investing public. Maco, *supra* note 3. Each syndicate member agrees to underwrite a specified percentage of the total offering and the underwriter's net profit or loss is calculated using that percentage. SODERQUIST, *supra*, at 37. The managing underwriter then collects a fee for its efforts, which is paid out of the proceeds of the sale. *Id.*

any person who offers or sells securities to investors on behalf of the issuer, and any person who participates with the underwriter in these activities.<sup>80</sup>

The underwriter's duty largely consists of helping the issuer sell the securities through an initial public offering.<sup>81</sup> The underwriter fulfills this duty by entering into either a "firm commitment" or "best efforts" underwriting.<sup>82</sup> In a firm commitment underwriting, the underwriter purchases the securities from the issuer at an agreed price and then attempts to resell those securities to the public for a profit.<sup>83</sup> As its name indicates, a best efforts underwriting involves the underwriter's or underwriting syndicate's promise to use its "best efforts" to sell a specific quantity of securities.<sup>84</sup>

### C. Financial Advisors

Financial advisors may also participate in a municipal securities offering.<sup>85</sup> Sometimes the underwriter assumes the role of financial advisor, and in other cases, an independent financial firm that neither underwrites nor distributes the securities renders advisory services.<sup>86</sup> Issuers retain financial advisors in both competitively-bid and negotiated offerings.<sup>87</sup> In a competitively-bid offering, the advisor provides the issuer with suggestions regarding the structure of the transaction and aids in the collection, preparation, review, and analysis of the information to be included in the official statement and given to the various ratings agencies for evaluation.<sup>88</sup> Less frequently, a financial

---

80. As originally defined in Rule 15c2-12 (e)(8), the term "underwriter" includes "any person who has purchased from an issuer of municipal securities with a view to, or offers or sells for an issuer of municipal securities in connection with, the offering of any municipal security, or participates or has a direct or indirect participation in any such undertaking." 17 C.F.R. § 240.15c2-12(e)(8) (1994). The federal securities laws impose relatively well-established responsibilities on underwriters in primary municipal securities offerings, which depend on the type of offering. For a discussion of underwriters' responsibilities under the federal antifraud provisions, see *infra* part III.A.

81. SODERQUIST, *supra* note 80, at 37. Unlike corporate offerings, which use a negotiation procedure, municipal offerings usually employ a competitive bidding process. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 9.

82. SODERQUIST, *supra* note 80, at 37-38.

83. *Id.* at 37.

84. *Id.* Underwriters acting pursuant to a best efforts agreement may contract to sell either whatever portion of the total they can, all of a determined amount of securities, an agreed minimum percentage of the securities, or none of the securities. *Id.* A best efforts underwriting presents less risk to the underwriter than does a firm commitment underwriting. *Id.* at 38. Smaller underwriters therefore almost exclusively use a best efforts underwriting. *Id.*

85. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 9.

86. *Id.*

87. *Id.*

88. *Id.*

advisor participates in a negotiated offering by acting as the issuer's agent to bargain for the securities' terms of sale to the underwriter, assisting in the preparation of the offering statement, and overseeing the actual offering of the securities.<sup>89</sup>

#### *D. Trustees and Legal Counsel*

Beyond the issuer, the underwriter, and the financial advisor, a municipal offering may involve a trustee. In many offerings, particularly those utilizing revenue bonds, the bond indenture or resolution appoints a bank as trustee.<sup>90</sup> The trustee bank functions as a registrar and paying agent and may also act on the bondholders' behalf following a default.<sup>91</sup> Furthermore, each of the major players discussed above generally retain legal counsel to represent their interests, to provide advice during the term of the financing, and to perform other related services.<sup>92</sup> Counsel involved in a primary offering of municipal securities include bond counsel, which oversees the entire offering, underwriter's counsel, governmental issuer's counsel, special disclosure counsel, and borrower's counsel.<sup>93</sup> The need for counsel stems from the fact that every participant in a municipal securities offering is subject to a series of intricate regulations concerning such offerings.

### III. CURRENT REGULATION OF THE MUNICIPAL SECURITIES MARKET

Current municipal disclosure practices originate from several sources. Specifically, municipal securities disclosure practices are governed by the antifraud provisions of the federal securities laws and case law interpreting those provisions, state "Blue Sky" laws, common law fraud principals,<sup>94</sup> voluntary guidelines, and government regulation of market participants. Among the applicable regulatory provisions, the federal securities laws are of paramount importance.

---

89. *Id.* Financial advisors involved in competitively bid offerings who have access to issuer data and participate in drafting the disclosure documents have an obligation comparable to that of underwriters under the federal antifraud provisions. Release No. 26,100, *supra* note 23, at 18,187 n.92.

90. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 10.

91. *Id.*

92. *Id.* at 11.

93. *Id.* at 11-22.

94. For example, a private action based on breach of warranty, rescission, or the action of deceit may provide injured investors with a remedy where state or federal securities laws fail to offer relief. *Id.* at 62. An aggrieved investor might also proceed under a breach of fiduciary duty theory. SODERQUIST, *supra* note 80, at 223.

### A. The Federal Antifraud Provisions

Although Congress exempted municipal securities offerings from the registration and civil liability provisions of the Securities Act and the periodic reporting requirements of the Exchange Act, Congress did not exclude such transactions from the antifraud provisions of Section 17(a) of the Securities Act,<sup>95</sup> Section 10(b) of the Exchange Act,<sup>96</sup> and Rule 10b-5,<sup>97</sup> promulgated under Exchange Act Section 10(b).<sup>98</sup> Collectively, these provisions prohibit any person, in connection with the offer, purchase, or sale of any security, from making a false or misleading statement of material fact or omitting any material fact necessary to render that person's statements not misleading.<sup>99</sup> Material facts and omissions consist of "matters which . . . [the average prudent] investor needs to know before he can make an intelligent, informed decision whether or not to buy the security."<sup>100</sup>

For example, in *TSC Industries v. Northway, Inc.*,<sup>101</sup> the United States Supreme Court described this materiality standard as "a show-

---

95. 15 U.S.C. § 77q(a). Section 17(a) prohibits any person in the offer or sale of any securities by use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly to employ any device, scheme, or artifice to defraud, or to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make that statements made, in light of the circumstances under which they were made, not misleading, or to engage in any transaction, practice, or course of business which operates or would operate as fraud or deceit upon the purchaser.

*Id.*

96. *Id.* § 78j(b). Section 10(b) makes it unlawful for "any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." *Id.*

97. 17 C.F.R. § 240.10b-5 (1994). Rule 10(b)(5) provides that [i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails . . . [t]o employ any device, scheme, or artifice to defraud, [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.*

98. Release No. 33,741 *supra* note 23, at 12,749.

99. *Id.* at 12,753.

100. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 680-81 (S.D.N.Y. 1968) (citing 17 C.F.R. § 230.405(1)).

101. 426 U.S. 438 (1976). Rather than Rule 10b-5, this case arose under Rule 14a-9, promulgated under Section 14(a) of the 1934 Act. The language of Rule 14a-9 is similar to that of Rule 10b-5 and provides that no proxy solicitation shall be made "which . . . is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. § 240.14a-9 (1995). In *TSC Industries*,



ing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]."<sup>102</sup> The Court further explained that a matter is material if "a substantial likelihood [exists] that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."<sup>103</sup> The Court stated that generally, "minor inaccuracies" or other secondary matters do not concern the reasonable investor.<sup>104</sup> Rather, facts that affect the "nature or condition" of the issuer influence investment decisions.<sup>105</sup> Later, in *Basic, Inc. v. Levinson*,<sup>106</sup> the Court expressly adopted the *TSC Industries* standard of materiality in the Section 10(b) and Rule 10b-5 context.<sup>107</sup>

The Commission has clarified the obligations of municipal market participants under the antifraud provisions in three interpretive releases.<sup>108</sup> These releases emphasize that the issuer bears the principal disclosure responsibility.<sup>109</sup> For instance, the antifraud provisions' prohibition against false or misleading statements of material facts applies to issuers preparing disclosure documents such as official statements.<sup>110</sup> The interpretive releases also describe the underwriter's due diligence responsibilities under the antifraud provisions.<sup>111</sup> An

---

the Supreme Court held that omissions from the TSC Industries' proxy statement regarding degree of control of National Industries, Inc. and of the desirability of terms of a proposal providing for the exchange of TSC common and Series 1 preferred stock for National Series B preferred stock and warrants were not materially misleading. 426 U.S. at 440-43, 463.

102. 426 U.S. at 449.

103. *Id.*

104. *BarChris*, 283 F. Supp. at 681.

105. *Id.*

106. 485 U.S. 224 (1988).

107. *Id.* at 230-32.

108. See *supra* note 23 (listing the three releases).

109. Release No. 26,985 *supra* note 23, at 18,199-211.

110. *Id.* at n.84 ("Because they are ultimately liable for the content of their disclosure, issuers should insist that any persons retained to assist in preparation of their disclosure documents have a professional understanding of the disclosure requirements under the federal securities laws.").

111. Release No. 26,985 *supra* note 23, at 18,199-200; Release No. 26,100, *supra* note 23, at 18,183-89; see also *Feeney v. SEC*, 564 F.2d 260, 262 (8th Cir. 1977) (expressing that professional securities underwriters "have a direct obligation to the public to investigate the relative value of securities offered by them and to appraise the public of material facts respecting the face value of such securities"); *Nassar & Co., Securities Exchange Act Release No. 13,081*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,904, at 81,120 (Dec. 17, 1976) (finding that Nassar willfully violated the antifraud provisions where it engaged in "a high-pressure sales effort, characterized by flamboyant representations and price predictions which lacked any semblance of an adequate foundation"); *Shearson, Hammill & Co., Securities Exchange Act Release No. 7743*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,306 (Nov. 12, 1965) (holding that a registered broker-dealer and investment advisor violated the registration provisions of the 1933 Act, the federal antifraud provisions, the 1934 Act, and the Investment Advisor's Act where the broker-

underwriter must possess a "reasonable basis" for recommending any security to an investor<sup>112</sup> and implies by his recommendation that he has made a reasonable investigation and that his recommendation rests upon conclusions drawn from such investigation.<sup>113</sup> Moreover, the underwriter's relationship with the issuer gives the underwriter ac-

---

dealer and investment advisor offered, sold, and delivered unregistered securities, bid for and purchased securities during distribution, represented that securities were offered at or about market price although it dominated and controlled the market, published bid quotations that were not bona fide, purchased securities from partner and employee during "work out" market while refusing to execute customers' prior sell orders at lower prices, made fraudulent representations in offer and sale of securities, effected sales of securities at excessive markups, induced excessive trading, and executed unauthorized transactions in customer accounts slightly below break points); Cortlandt Investing Corp., Securities Exchange Act Release No. 7682, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,273 (Aug. 29, 1965) (finding a violation of the federal antifraud provisions where, in connection with the offer and sale of securities, a registered broker-dealer made fraudulent representations and predictions and distributed market letters containing misrepresentations regarding, among other things, increases in the stock's price, the issuer's financial condition, past and projected sales and earnings, and future dividend payments).

112. Release No. 26,100, *supra* note 23, at 18,184-85 (citing *In re Walston & Co.*, Securities Exchange Act Release No. 8165, [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,474 (Sept. 22, 1967)). *Walston* involved a special assessment tax district, which consisted of one tract of undeveloped land owned by the bonds' promoter. *Id.* Although the firm did not inquire into the developer's financial condition, the manager of the bond department knew that the district consisted solely of one individual's land. *Id.* The SEC noted:

It is incumbent on firms participating in an offering and on dealers recommending municipal bonds to their customers as "good municipal bonds" to make diligent inquiry, investigation and disclosure as to material facts relating the issuer of the securities and bearing upon the ability of the issuer to service such bonds. It is, moreover, essential that dealers offering such bonds to the public make certain that the offering circular and other selling literature are based on an adequate investigation and the they accurately reflect all material facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision.

*Id.*

113. *Id.* at 18,184 (citing *Hanley v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969)); *see also Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1069-70 (7th Cir. 1975), *vacated and remanded on other grounds*, 425 U.S. 929 (1976), *on remand*, 554 F.2d 790 (7th Cir. 1977), *reh'g denied*, 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981) ("Since the underwriter is unquestionably aware of the nature of the public's reliance on his participation in the sale of the issue, the mere fact that he has underwritten it is an implied representation that he has met the standards of his profession in his investigation of the issuer."); *In re Hamilton Grant & Co.*, Securities Exchange Act Release No. 6724, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,146, at 88,993 (July 7, 1987) ("By associating himself with a proposed offering, an underwriter impliedly represents that he has made . . . an investigation . . . in accordance with professional standards. Investors properly rely on this added protection which has a direct bearing on their appraisal of the reliability of the representations in the prospectus.") (citing *In re Richmond Corp.*, Securities Act Release No. 4584 [1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,904, at 81,342-43 (Feb. 27, 1963)); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Securities Exchange Act Release No. 14,149, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,365, at 650-51 (Nov. 9, 1977) ("A recommendation by a broker-dealer is perceived by a customer as (and in fact it should be) the product of an independent and objective analysis can [sic] only be achieved when the scope of the investigation is extended beyond the company's management.").

cess to facts that are not publicly available.<sup>114</sup> Therefore, a municipal underwriter must disclose facts that he knows and those that he can reasonably ascertain.<sup>115</sup>

Whether a municipal underwriter has complied with his due diligence obligations under the federal antifraud provisions depends on the facts and circumstances of each case.<sup>116</sup> At a minimum, the SEC interpretive releases suggest that underwriters review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions.<sup>117</sup> Beyond this threshold level of review, an underwriter's reasonable basis may depend on (1) the extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties have given them knowledge of particular facts; (2) the role of the underwriter, i.e., managing underwriter or syndicate member; (3) the type of bonds offered, i.e., general obligation bonds, revenue bonds, or conduit bonds; (4) the past familiarity of the underwriter with the issuer; (5) the length of time to maturity of the bonds; and (6) whether the bonds are competitively-bid or are distributed in a negotiated offering.<sup>118</sup>

Finally, the SEC interpretative guidelines discuss the responsibilities of municipal securities dealers.<sup>119</sup> A dealer may not recommend transactions in the secondary municipal market "[i]f, based on publicly available information, a dealer discovers any factors that indicate the disclosure is inaccurate or incomplete, or signal the need for fur-

---

114. *Sanders*, 524 F.2d 1064, 1069-70 (7th Cir. 1975) (stating underwriters have access to facts "not equally available to members of the public who must rely on published information"); see also *Levine v. SEC*, 436 F.2d 88 (2d Cir. 1971) (upholding the SEC's revocation of a securities salesman's registration for antifraud violations where "virtually every aspect of the [issuing] company's operations" were discussed with him).

115. Release No. 26,100, *supra* note 23, at 18,183-84 (citing *Hanley v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969)).

116. *Id.* at 18,186.

117. *Id.*

118. Release No. 26,985 *supra* note 23, at 18,199-211; Release No. 26,100, *supra* note 23, at 18,186. For example, in a competitively-bid offering that involves an established municipal issuer, an underwriter fulfills its reasonable basis requirement simply by reviewing the issuer's official statement in a professional manner and obtaining from the issuer a detailed and credible explanation concerning any aspect of the official statement that appears on its face, or based on information available to the underwriter, to be inadequate. *Id.* at 18,187. Similarly, in negotiated offerings, where the underwriter helps prepare the official statement, a municipal underwriter satisfies its reasonable basis requirement by inquiring in a professional manner into the key representations contained in the official statement. *Id.* Unlike underwriters of competitively bid offerings, underwriters participating in a negotiated municipal offerings may not rely on the issuer's representations, but must draw on their own experience with that particular issuer, other issuers, and their general knowledge of the municipal markets in formulating a reasonable basis for recommending the issue. *Id.*

119. Release No. 33,741 *supra* note 23, at 12,755.

ther inquiry . . . .”<sup>120</sup> If a dealer suspects that the issuer’s disclosure is inaccurate, the federal antifraud provisions require that the dealer attempt to verify the publicly available information or, if the public disclosure is incomplete, to obtain additional information about the securities.<sup>121</sup> Absent adequate disclosure of financial and operating information by a particular issuer, the federal antifraud provisions prohibit dealers from recommending transactions in that issuer’s securities.<sup>122</sup>

### B. State Blue Sky Laws

In addition to the federal antifraud provisions, state “Blue Sky” laws govern municipal issuer disclosure practices. Prior to the enactment of the Securities Act in 1933 and the Exchange Act in 1934, securities regulation was governed exclusively by state securities laws.<sup>123</sup> The 1933 and 1934 Acts do not preempt state Blue Sky laws.<sup>124</sup> For instance, the Uniform Securities Act,<sup>125</sup> adopted entirely or in part by 37 states, expressly grants states the authority to regulate securities issued in that state.<sup>126</sup> Although the Uniform Act exempts municipal offerings from its registration provisions, several states impose separate filing requirements on municipal issuers.<sup>127</sup> Municipal issuers in these states must file a notice before offering or selling municipal securities.<sup>128</sup> Some states limit their filing requirements to certain types of municipal securities, such as industrial development bonds.<sup>129</sup> Others require full registration.<sup>130</sup> Like the federal securities laws, the Uniform Act contains general antifraud provisions similar to Section 10(b) and Section 17(a) of the 1934 Act.<sup>131</sup>

---

120. *Id.* at 12,758.

121. *Id.*

122. *Id.*

123. SODERQUIST, *supra* note 80, at 16.

124. DISCLOSURE RULES OF COUNSEL, *supra* note 5, at 59. For example, the 1933 Act created exemptions from the federal registration requirements for private and intrastate offerings, which are regulated by the states. *Id.*

125. UNIF. SEC. ACT, 7B U.L.A. 509 (1985 & Supp. 1993).

126. SODERQUIST, *supra* note 80, at 16.

127. *Id.*

128. *Id.*

129. *Id.* For example, New York and Ohio follow this approach. DISCLOSURE RULES OF COUNSEL, *supra* note 4, at 59 n.148.

130. *Id.* Maine, Texas and Washington, for instance, effectively require full registration for public offerings of industrial development bonds. *Id.* at 59 n.149.

131. *Id.* at 61. Section 101 of the Uniform Act provides:

It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they

### C. Industry Practice and Voluntary Guidelines

Beyond the mandatory disclosure obligations imposed on issuers, underwriters, and dealers under the federal antifraud provisions and state Blue Sky laws, numerous organizations have promulgated voluntary guidelines for municipal market participants.<sup>132</sup> Voluntary compliance is intended to promote full and accurate disclosure in the municipal securities markets.<sup>133</sup> Of the numerous organizations that have adopted specific municipal disclosure guidelines, the Government Finance Officers Association (GFOA) has pioneered the improvement of municipal issuer disclosure by publishing its *Disclosure Guidelines for State and Local Government Securities*.<sup>134</sup> Although the GFOA *Guidelines* lack the force of law, they represent the prevailing view of market participants regarding proper disclosure in municipal securities transactions.<sup>135</sup> Therefore, like SEC forms, which assist issuers in complying with disclosure requirements for registered offerings under the 1933 Act, the GFOA *Guidelines* serve as the industry standard for disclosure in municipal offerings.<sup>136</sup>

The GFOA *Guidelines* recommend that the issuer's official statement contain a summary of its financial practices and results of operation and financial statements prepared in conformity with generally accepted accounting principals and audited in accordance with generally accepted auditing standards.<sup>137</sup> With respect to the obligations of conduit issuers, the GFOA advises that the official statement include information regarding the conduit's form of organization and management, rate-making or pricing policies, historical results of operations, and a projected operating plan.<sup>138</sup> Finally, if the issue involves a credit

---

are made, not misleading, or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

UNIF. SEC. ACT, 7B U.L.A. 509, 516 (1985 & Supp. 1993).

132. Maco, *supra* note 3. The Public Securities Association's *Recommendations for a Consistent Presentation of Basic Bond Provisions in Official Statements* and the National Federation of Municipal Analysts' *NFMA Handbook* are two examples of such voluntary guidelines. *Id.* Other organizations that have devised policies on municipal market disclosure include the National Association of State Auditors, Comptrollers and Treasurers, the Government Accounting Standards Board, the National Counsel of State Housing Agencies, and the National Counsel of Health Care Facilities Financing Authorities. Staff Report, *supra* note 6, at 66 n.98.

133. Release No. 33,741, *supra* note 23, at 12,748.

134. Staff Report, *supra* note 6, at 35.

135. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 80.

136. *Id.* at 79. Significantly, the SEC views the GFOA *Guidelines* as a means by which to "assist issuers in fulfilling their current obligations under the general antifraud provisions of the federal securities laws." Release No. 26,985, *supra* note 22, at 18,195 n.31.

137. Release No. 33,741, *supra* note 23, at 12,751.

138. *Id.* at 12,757. For a discussion of conduit issues, see *supra* notes 32-34 and accompanying text.

enhancement, such as bond insurance or a letter of credit, the GFOA *Guidelines* suggest that the issuer disclose information regarding the nature and extent of the credit enhancement as well as financial and business information about the credit enhancement provider.<sup>139</sup>

#### *D. Government Regulation of Market Participants*

In addition to the GFOA, which controls municipal issuer disclosure on a voluntary basis, the Municipal Securities Rulemaking Board (MSRB), the National Association of Securities Dealers, Inc. (NASD), and the SEC each regulate the conduct of brokers, dealers, and municipal securities dealers under Section 15 of the Exchange Act.<sup>140</sup> Generally, Section 15 governs broker-dealer registration and regulation at the federal level.<sup>141</sup> In particular, Section 15(c) aims to prevent fraud, while Section 15B contains special provisions concerning the registration of municipal securities dealers and provides for the regulation of brokers, dealers, and municipal securities dealers, including regulation by the MSRB.<sup>142</sup>

##### *1. The Tower Amendment*

The Securities Act Amendments of 1975,<sup>143</sup> commonly referred to as the "Tower Amendment," created the MSRB and gave the SEC broad rulemaking and enforcement authority over all municipal brokers and dealers.<sup>144</sup> The Tower Amendment also requires firms that deal only in municipal securities on an interstate basis to register with the SEC as broker-dealers and gives the NASD enforcement authority over these firms.<sup>145</sup> Under the SEC's supervision, the MSRB has the authority to regulate municipal securities brokers and dealers in such areas as professional qualifications, recordkeeping, quotations, and advertising.<sup>146</sup> Although rules promulgated by the MSRB have the force of law, the MSRB, unlike other self-regulatory organizations, does not possess inspection or enforcement powers.<sup>147</sup> Moreover, the Tower Amendment prohibits both the SEC and the MSRB

---

139. *Id.* at 12,752. For a discussion of credit enhancements, see *supra* part I.B.

140. 15 U.S.C. § 78o.

141. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 70-71.

142. *Id.* at 71.

143. Pub. L. No. 94-29, 89 Stat. 131 (1975).

144. Staff Report, *supra* note 6, at 18. Notwithstanding that the Tower Amendment actually only added Section 15B(d)(2), which imposes disclosure limitations on the MSRB, the 1975 Amendments are collectively referred to as the "Tower Amendment." *Id.* at 59 n.37.

145. *Id.*

146. *Id.* at 19.

147. DISCLOSURE ROLES OF COUNSEL, *supra* note 5, at 72.

from directly or indirectly requiring municipal issuers to file any application, report, or document prior to issuing securities.<sup>148</sup> The Tower Amendment does not, however, preclude the SEC from promulgating disclosure standards for municipal offerings, despite the absence of express statutory authority in the Exchange Act over municipal issuer disclosure.<sup>149</sup>

## 2. Rule 15c2-12

Besides granting the MSRB authority to regulate municipal securities brokers and dealers, Section 15(c) of the 1934 Act authorizes the SEC to promulgate rules and regulations to define and prevent fraudulent acts and practices by brokers, dealers, and municipal securities dealers.<sup>150</sup> Specifically, Section 15(c)(2) prohibits brokers, dealers, and municipal securities dealers from employing fraudulent techniques to induce investors to purchase or sell securities.<sup>151</sup> In 1989, the SEC exercised its authority under Section 15(c)(2) by adopting Rule 15c2-12 to promote timely and accurate disclosure in the municipal securities markets.<sup>152</sup> This Section discusses the provisions of the Rule as originally enacted in 1989.

Rule 15c2-12 imposes several administrative responsibilities on underwriters. First, the Rule requires the underwriter of a primary offering<sup>153</sup> of municipal securities with a total principal amount of one million dollars or more to obtain and review the issuer's preliminary official statement prior to conducting any transaction related to the offering.<sup>154</sup> Second, in negotiated offerings, the underwriter must pro-

---

148. Staff Report, *supra* note 6, at 19-20. In particular, Exchange Act Section 15(d)(2) prohibits the MSRB from exercising direct authority over issuers and from regulating issuers indirectly through municipal securities brokers and dealers. *Id.* at 65 n.95.

149. *Id.* at 20.

150. 15 U.S.C. § 78o(c).

151. *Id.* § 78o(c)(2).

152. 17 C.F.R. § 240.15c2-12 (1994).

153. Paragraph (e)(7) of Rule 15c2-12 defines the term "primary offering" as an offering of municipal securities directly or indirectly by or on behalf of an issuer of such securities, including any remarketing of municipal securities . . . [t]hat is accompanied by a change in the authorized denomination of such securities from \$100,000 or more to less than \$100,000, or [t]hat is accompanied by a change in the period during which such securities may be tendered to an issuer of such securities or its designated agent for redemption or purchase from a period of nine months or less to a period of more than nine months.

*Id.* § 240.15c2-12(e)(7).

154. Paragraph (b)(1) of Rule 15c2-12 provides:

Prior to the time the Participating Underwriter bids for, purchases, offers, or sells municipal securities in an Offering, the Participating Underwriter shall obtain and review an official statement that an issuer of such securities deems final as of its date, except for the omission of no more than the following information: The offering price(s), inter-

vide the issuer's most recent "preliminary official statement"<sup>155</sup> to "potential customers"<sup>156</sup> upon request from the time the underwriter becomes involved in the offering until the issuer completes its "final official statement."<sup>157</sup> Third, in all offerings, the Rule requires the underwriter to contract with the issuer to receive sufficient copies of the issuer's final official statement to comply with this delivery requirement and with those of the MSRB.<sup>158</sup> Fourth, Rule 15c2-12 obligates the underwriter to furnish copies of the issuer's final official statement to customers who request it for up to ninety days following the end of the underwriting period.<sup>159</sup>

---

est rate(s), selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, other terms of the securities depending on such matters, and the identity of the underwriter(s).

*Id.* § 240.15c2-12(b)(1).

155. Paragraph (e)(6) of Rule 15c2-12 defines "preliminary official statement" as "an official statement prepared by or for an issuer of municipal securities for dissemination to potential customers prior to the availability of the final official statement." *Id.* § 240.15c2-12(e)(6).

156. Paragraph (e)(5) defines "potential customer" as

[a]ny person contacted by the Participating Underwriter concerning the purchase of municipal securities that are intended to be offered or have been sold in an offering, [a]ny person who has expressed an interest to the Participating Underwriter in possibly purchasing such municipal securities, and [a]ny person who has a customer account with the . . . [u]nderwriter.

*Id.* § 240.15c2-12(e)(5).

157. Paragraph (b)(2) states:

Except in competitively bid offerings, from the time the Participating Underwriter has reached an understanding with an issuer of municipal securities that it will become a Participating Underwriter in an Offering until a final official statement is available, the Participating Underwriter shall send no later than the next business day, by first class mail or other equally prompt means, to any potential customer, on request, a single copy of the most recent preliminary official statement, if any.

*Id.* § 140.15c2-12(b)(2).

Paragraph (e)(3) of the Rule defines "final official statement" as a document or set of documents prepared by an issuer of municipal securities or its representatives setting [sic] forth, among other matters, information concerning the issuer(s) of such municipal securities and the proposed issue of securities that is complete as of the date of delivery of the document or set of documents to the Participating Underwriter.

*Id.* § 240.15c2-12(e)(3).

158. Paragraph 15c2-12(b)(3) requires the underwriter to

contract with an issuer of municipal securities or its designated agent to receive, within seven business days after any final agreement to purchase, offer, or sell the municipal securities in an Offering and in sufficient time to accompany any confirmation that requests payment from any customer, copies of a final official statement in sufficient quantity to comply with paragraph (b)(4) of this rule and the rules of the Municipal Securities Rulemaking Board.

*Id.* § 240.15c2-12(b)(3).

159. Paragraph (b)(4) requires:

From the time the final official statement becomes available until the earlier of (i) Ninety days from the end of the underwriting period or (ii) The time when the official



Rule 15c2-12 does not apply to primary offerings issued in "authorized denominations of \$100,000 or more,"<sup>160</sup> if one of three specific exemptions apply.<sup>161</sup> These exemptions are for limited placements, short-term securities, and securities with demand features.<sup>162</sup> The limited placement exemption excludes securities from Rule 15c2-12 if the underwriter sells securities to no more than thirty-five sophisticated investors who purchase the securities for only one account without intending to distribute them.<sup>163</sup> The short-term securities exemption applies to securities with a maturity of nine months or less.<sup>164</sup> Finally, securities with demand features, which allow the investor to tender the securities to the issuer at least once every nine months until maturity, or which provide some other means of early redemption, do not come under Rule 15c2-12.<sup>165</sup> Beyond these particular exemptions,

---

statement is available to any person from a nationally recognized municipal securities information repository, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in an Offering shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the final official statement.

*Id.* § 240.15c2-12(b)(4). The Rule defines the "end of the underwriting period" as "the later of such time as the issuer of municipal securities delivers the securities to the Participating Underwriters or the Participating Underwriter does not retain, directly or as a member of an underwriting syndicate, an unsold balance of the securities for sale to the public." *Id.* § 240.15c2-12(e)(2). A "nationally recognized municipal securities information repository" consists of a central repository for the collection and dissemination of official statements and other secondary market information. Release No. 26,985, *supra* note 23, at 18,199-204. NRMSIRs are instrumental in effectuating the dissemination provisions of amended Rule 15c2-12. For a discussion of NRMSIRs in the context of amended Rule 15c2-12, see *infra* part IV.B.3.a.

160. Under Paragraph (e)(1) of the Rule, "authorized denominations of \$100,000 or more" means "municipal securities with a principal amount of \$100,000 or more and with restrictions that prevent the sale or transfer of such securities in principal amounts of less than \$100,000 other than through a primary offering; except that, for municipal securities with an original issue discount of 10 percent or more, the term means municipal securities with a minimum purchase price of \$100,000 or more and with restrictions that prevent the sale or transfer of such securities, in principal amounts that are less than the original principal amount at the time of the primary offering, other than through a primary offering. 17 C.F.R. § 240.15c2-12(e)(1).

161. *Id.* § 240.15c2-12(c).

162. *Id.*

163. *Id.* § 240.15c2-12(c)(1). Paragraph (c)(1) specifically exempts an offering of municipal securities that

[a]re sold to no more than thirty-five persons each of whom the Participating Underwriter reasonably believes has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment and is not purchasing for more than one account or with a view to distributing the securities.

*Id.*

164. *Id.* § 240.15c2-12(c)(2).

165. Under Rule 15c2-12, tender option securities include securities that, "[a]t the option of the holder thereof may be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until

Rule 15c2-12 contains a transactional exemption pursuant to which the SEC may use its discretion to exclude certain municipal transactions from any requirement of Rule 15c2-12.<sup>166</sup>

#### IV. REGULATION OF THE MUNICIPAL SECURITIES MARKET UNDER AMENDED RULE 15c2-12

In March 1994, the SEC published for comment proposed amendments to Rule 15c2-12.<sup>167</sup> On November 17, 1994, with some changes based on comments from municipal market participants, the SEC adopted these proposed amendments.<sup>168</sup> Amended Rule 15c2-12 imposes several new obligations on underwriters related to municipal market disclosure. First, the amended Rule prohibits underwriters from purchasing or selling municipal securities without first determining that the issuer has contracted to provide specified annual financial information and material event notices to various information repositories.<sup>169</sup> Second, the amended Rule prohibits dealers from recommending the purchase or sale of municipal securities in the secondary market unless they adopt procedures that reasonably assure prompt receipt of material event notices.<sup>170</sup> Amended Rule 15c2-12 follows the Commission's established approach to municipal disclosure, which relies on market discipline and compliance with the federal antifraud provisions to promote full and accurate disclosure.<sup>171</sup> This Section begins by discussing the weaknesses of current municipal disclosure practices. Next, this Section summarizes the provisions of amended Rule 15c2-12 and compares its requirements to those of the 1989 Rule.

---

maturity, earlier redemption, or purchase by an issuer or its designated agent. *Id.* § 240.15c2-12(c)(3).

166. *Id.* § 240.15c2-12(d). This transactional exemption provides:

The Commission, upon written request, or upon its own motion, may exempt any Participating Underwriter that is a participant in a transaction or class of transactions from any requirement of this rule, either unconditionally or on specified terms and conditions, if the Commission determines that such an exemption is consistent with the public interest and the protection of investors.

*Id.*

167. Municipal Securities Disclosure—Proposed Rulemaking, Securities Exchange Act Release No. 33,742, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,324 (March 9, 1994).

168. Release No. 34,961, *supra* note 5.

169. *Id.* at 85,951.

170. *Id.*

171. *U.S. Securities and Exchange Commission Open Meeting Fact Sheet, THE BOND BUYER*, Nov. 10, 1994, at 6.

### A. *The Problems With Current Municipal Disclosure Practices*

As discussed above, municipal securities are for the most part exempt from the federal securities laws.<sup>172</sup> Furthermore, Exchange Act Section 15(d)(2) prohibits the MSRB from exercising direct authority over issuers or from regulating issuers indirectly through municipal securities brokers and dealers.<sup>173</sup> Therefore, the federal antifraud provisions and state Blue Sky laws continue to provide the principal means by which municipal issuer disclosure is regulated.<sup>174</sup>

#### 1. *Disclosure in the Primary Market Lacks Uniformity*

This regulatory framework has markedly improved municipal issuer disclosure. For example, under the direction of the GFOA *Guidelines*, municipal issuers now prepare more extensive official statements.<sup>175</sup> Better municipal market disclosure has also resulted from requirements imposed on municipal underwriters under Rule 15c2-12 and MSRB Rule G-32 and market pressures, such as perceived investor demand for information.<sup>176</sup>

Nonetheless, primary market disclosure remains deficient in some respects.<sup>177</sup> Specifically, reliance on market pressures and voluntary compliance has engendered uneven disclosure practices.<sup>178</sup> The form and content of municipal issuer official statements vary widely, depending on the size of the issuer and the frequency with which it comes to the market.<sup>179</sup> While the official statements of large municipal issuers generally include extensive documents that meet or exceed the GFOA *Guidelines*, the official statements of smaller, less frequent issuers typically consist of a one or two page document describing the

---

172. But see *supra* part III.A for a discussion of the responsibilities of municipal market participants under the federal antifraud provisions.

173. Staff Report, *supra* note 6, at 65 n.95.

174. *Id.* at 35.

175. *Id.* at 38. For a discussion of the GFOA *Guidelines*, see *supra* part III.C.

176. *Id.* at 35, 38.

177. *Id.* at 38.

178. *Id.*

179. *Id.* As explained in the Staff Report:

In the absence of universal mandatory standards, disclosure quality is subject to issuer judgments regarding the value of detailed disclosure with regard to the price received in the offering and the requirements of the anti-fraud provisions, versus the burden on issuer officials, legal costs, and the potential effect on the offering of negative disclosures. As municipal issuers come to differing conclusions regarding such factors, municipal offering documents can differ enormously in extent and detail.

*Id.* at 38-39.

offering, which is accompanied by sales literature prepared by the managing underwriter.<sup>180</sup>

## 2. *Municipal Issuers Lack Incentives to Provide Ongoing Disclosure to the Secondary Market*

Like those in the primary market, disclosure practices in the secondary municipal market also need improvement. In contrast to public companies subject to the reporting requirements of the 1934 Act, municipal issuers are not required to file periodic reports with the Commission.<sup>181</sup> Trading in the secondary municipal market therefore depends on the issuer's voluntary distribution of periodic financial statements and disclosure of financial information in subsequent official statements.<sup>182</sup> Two results obtain from such sporadic secondary municipal market disclosure practices. First, the lack of continuing financial disclosure prevents individual investors, who now represent the largest municipal market segment, from making fully informed investment decisions.<sup>183</sup> Second, the development of sophisticated credit structures and derivative municipal securities could be inhibited by a lack of timely and accurate market information.<sup>184</sup>

Poor secondary market disclosure has direct and indirect effects on individual investors. Inefficiencies in the secondary municipal market directly impair individual investors' ability to acquire the information necessary to enable them to make intelligent, informed investment decisions.<sup>185</sup> The lack of continuing disclosure indirectly affects individual investors by increasing their reliance on the advice of financial intermediaries, particularly municipal securities dealers, which makes competent municipal dealer investment advice even more important.<sup>186</sup> The lack of municipal issuer financial information, however, prevents municipal securities dealers from accurately valuing the securities that they sell.<sup>187</sup> This further inhibits the correct pricing of municipal securities because market participants know that their transactions may be executed based on incorrect or deficient informa-

---

180. *Id.* at 38.

181. *Id.* at 39.

182. *Id.*

183. *Id.*

184. *Id.* at 40.

185. *Id.* at 39.

186. *Id.* at 39-40.

187. *Id.* at 39.

tion about the securities.<sup>188</sup> Investors factor these inaccuracies into the pricing of municipal market transactions.<sup>189</sup>

As discussed above, the complexity of the municipal market has increased dramatically with the expanded use of credit enhancements, conduit issues, and derivative products.<sup>190</sup> For instance, housing bonds<sup>191</sup> possess characteristics similar to those of collateralized mortgage obligations (CMOs).<sup>192</sup> Although housing bonds and CMOs subject investors to virtually identical risks, CMO issuers are subject to greater disclosure requirements than issuers of housing bonds.<sup>193</sup> Similarly, municipal and corporate derivatives share many of the same attributes—such as the pooling of secondary market securities—but municipal derivatives are exempt from the federal securities laws that apply to derivative securities issued by public companies.<sup>194</sup> The absence of continuing disclosure may inhibit the growth of the municipal derivative market because the lack of information regarding each component of municipal derivatives prevents accurate pricing of these products.<sup>195</sup> Such deficiencies prompted the SEC in 1994 to amend Rule 15c2-12.

### B. Amended Rule 15c2-12

This Section summarizes the provisions of amended Rule 15c2-12 and compares the Rule as enacted in 1989 with the amended Rule. First, this Section discusses the new responsibilities placed on underwriters. Next, this Section details the obligations that the amended Rule imposes on both underwriters and dealers to ensure that municipal issuers provide continuing disclosure of material financial information to the secondary market. Then, this Section addresses the role that information repositories play in effectuating the reporting provisions of the amended Rule. Finally, this Section concludes with a summary of the exemptions added by the amended Rule.

---

188. *Id.* at 39-40.

189. *Id.*

190. *Id.* at 40. See *supra* part II for a survey of various municipal financing structures.

191. Housing bonds, a type of industrial development bond, consist of short- or long-term debt instruments that are issued by a local housing authority to finance the construction of low or middle income housing. *Id.*

192. CMOs are pools of mortgages that typically pay semiannual interest. GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE* § 11.3 at 795-96 (3d ed. 1994). Usually the issuer of a CMO restructures the principal payments from the mortgages, which creates several bondlike securities with varying maturities. *Id.* at 796. The resulting security resembles an industrial development bond. *Id.*; see *supra* note 32 (defining "industrial development bond").

193. Staff Report, *supra* note 6, at 40.

194. *Id.*

195. *Id.*

### 1. *The Underwriter's Responsibility*

Amended Rule 15c2-12 significantly expands the responsibilities of underwriters with respect to municipal market disclosure. First, the amended Rule prohibits underwriters subject to the provisions of Rule 15c2-12 from purchasing or selling municipal securities in the primary market unless they first determine that an issuer or other "obligated person"<sup>196</sup> has contracted to disclose certain financial or operating information in the final official statement and on a continuing basis.<sup>197</sup> Specifically, the amended Rule requires underwriters to "reasonably determine" that the issue includes an undertaking by the issuer or other obligated person to provide annual financial information.<sup>198</sup> Second, the amended Rule dictates that undertakings involving bond pools set forth the objective criteria employed in determining who constitutes an obligated person.<sup>199</sup> The undertaking must therefore expressly identify the parties for whom continuing disclosure will be provided or, in pooled financings, specify the objective criteria that will be applied each year to determine the parties that continue to meet the Rule's definition of "obligated persons."<sup>200</sup>

---

196. The amended Rule defines an "obligated person" as

any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold . . . (other than providers of municipal bond insurance, letters or credit or other liquidity facilities).

Release No. 34,961, *supra* note 5, at 85,981.

197. *Id.* at 85,954. The SEC suggested that the parties may include the undertaking to provide financial information and operating data in a trust indenture, bond resolution or other legislation. *Id.* at 85,967. Alternatively, the parties could include the undertaking in the bond form itself. *Id.* The undertaking requirement creates a direct contractual obligation between the parties to the undertaking and bondholders. *Id.* Where a state statute prohibits the issuer from entering into long-term contracts, the undertaking may include qualifying language, such as that the issuer's obligation pursuant to the undertaking is subject to appropriation. *Id.*

198. *Id.* Paragraph (b)(5)(i) of the amended Rule provides:

A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent . . . annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement . . . .

*Id.* at 85,978-79.

199. *Id.* at 85,979.

200. *Id.*

The amended Rule does not require that the party who provides the undertaking be the same party to which the information relates.<sup>201</sup> Any issuer or obligated person for which the official statement provides information may undertake to provide disclosure for the entire issue.<sup>202</sup> In the adopting release issued in connection with the 1994 amendments, the SEC specified that an underwriter will satisfy its reasonable basis obligation under the new Rule if it determines that some party material to the offering has agreed to provide ongoing disclosure; it is not necessary for the underwriter to obtain an undertaking from all potential issuers and obligated persons.<sup>203</sup>

In contrast, Rule 15c2-12 as originally enacted merely required underwriters to obtain, review, and deliver the issuer's official statement.<sup>204</sup> The original Rule did not impose any obligations on the underwriter to confirm that the issuer or any other obligated party would provide disclosure beyond that contained in its official statement.<sup>205</sup> The amended Rule thus expands the due diligence obligations of underwriters under the federal antifraud provisions to include an investigation of the issuer's or obligated person's undertaking to provide secondary market disclosure.<sup>206</sup>

- a. The content of the final official statement determines the scope of the parties' obligations to provide secondary market disclosure

By requiring underwriters to determine that issuers and other obligated persons have undertaken to provide ongoing disclosure, the amended Rule imposes a concomitant duty on these parties to ascer-

---

201. *Id.* at 85,962.

202. *Id.*

203. *Id.* In issues such as conduit financings, where an obligated person constitutes the main, if not the only, source for repayment, this provision allows the governmental issuer to shift the undertaking to provide secondary market disclosure to that obligated person as the primary obligor. *Id.* Additionally, the participants in the offering may delegate disclosure responsibilities to a designated agent or indenture trustee. *Id.* For example, the parties may authorize the trustee to disseminate only specified information or give the trustee discretion to report the occurrence of certain events on its own initiative. *Id.*

204. 17 C.F.R. § 240.15c2-12 (1994). The original Rule required underwriters to obtain and review the issuer's "deemed final" official statement; to provide the issuer's most recent preliminary official statement, if any, in a negotiated offering; to deliver to customers, upon request, copies of the final official statement for a specified period; and to contract to receive sufficient copies of the official statement to comply with this delivery requirement and the delivery requirements under MSRB Rule G-32. *Id.* § 240.15c2-12(b); see *supra* part III.D.2 (discussing Rule 15c2-12 as enacted in 1989).

205. See 17 C.F.R. § 240.15c2-12(b) (providing only that the underwriter "obtain and review" the issuer's official statement).

206. See Release No. 34,961, *supra* note 5, at 85,961 (describing the provisions of the amended Rule impacting the underwriting of municipal securities).

tain the proper scope of such disclosure when preparing the final official statement. The financial information and operating data included in the final official statement also determine the extent of the obligations of issuers and other obligors to provide ongoing disclosure to the secondary market.<sup>207</sup> The Rule specifies that the final official statement contain financial information and operating data concerning the issuer and “those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the [o]ffering.”<sup>208</sup> The contents of the final official statement dictate what continuing financial information must be provided and who must provide it.<sup>209</sup> For example, if the official statement contains a party’s financial information or operating data, that party must continue to provide information to the secondary market as long as that party is contractually bound to support payment of the offering.<sup>210</sup> The amended definition of “final official statement” consequently includes contracts that involve payments made directly to bondholders, to issuers to be used to pay obligations on municipal securities, or through conduit arrangements.<sup>211</sup> The definition expressly excludes providers of bond insurance, letters of credit, and other liquidity facilities, such as lines of credit and bond purchase agreements, from the undertaking requirement.<sup>212</sup>

To summarize, the amended Rule requires the party designated as responsible for disclosure to expressly identify the parties for whom disclosure will be provided in the final official statement or, for pooled financings, set forth the objective criteria that will be applied to determine which parties constitute “obligated persons.” With respect to

---

207. *Id.* at 85,956.

208. *Id.* at 85,980. The amended Rule modifies the definition of “final official statement” to mean

a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering . . . .

*Id.* Notably, the definition of “obligated person” does not specify a threshold percentage of payment as a basis for determining materiality. *Id.* at 85,959. This flexible definition allows the issuer and other participants to ascertain who is material to the offering when they prepare the final official statement. *Id.* For the definition of “final official statement” under original Rule 15c2-12, see *supra* note 158.

209. Release No. 34,961, *supra* note 5, at 85,956.

210. *Id.*

211. *Id.* at 85,960. The definition includes parties that provide debt service through payments under a lease, loan, installment sale agreement, or other contract relating to use of a project, regardless of whether the issue employs a conduit arrangement or system or project financing. *Id.* at 85,960 n.74.

212. *Id.* at 85,961.



the scope of required disclosure, the amended Rule provides that the final official statement may cross-reference "publicly available" information.<sup>213</sup> Lastly, the final official statement must reveal if any party providing ongoing disclosure in connection with the offering has failed to comply with any previous undertakings to provide secondary market disclosure within the past five years.<sup>214</sup>

i. Non-pooled financings may employ a materiality standard

As indicated, the amended definition of "final official statement" requires issuers and others material parties to provide financial information and operating data in the official statement and on a continuing basis.<sup>215</sup> The new definition embodies the notion that flexible, yet enforceable, standards will promote the most meaningful secondary market disclosure.<sup>216</sup> The definition gives the parties the latitude to choose which obligors' financial information is material.<sup>217</sup> The definition further allows the parties to consider the type of issuer, the structure of the issue, and its sources of repayment when determining what information should be disclosed.<sup>218</sup> Although the amended definition of final official statement grants issuers great autonomy in preparing the final official statement, the Commission stated that market discipline and regulatory requirements, such as those of the MSRB,

---

213. *Id.* at 85,957. The amended Rule specifically provides that financial information or operating data may be set forth in the document or set of documents comprising the final official statement, or may be included by specific reference to documents previously provided. "If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board." *Id.* Under the Rule, "publicly available" information includes disclosure documents submitted to each national information repository and to the appropriate state information repository. *Id.* If the information concerns a company subject to the registration and reporting requirements of the federal securities laws, such as a corporate conduit borrower, "publicly available" information means disclosure documents filed with the SEC. *Id.* For an explanation of information repositories and their role under the amended Rule, see *infra* part IV.B.3.

214. Release No. 34,961, *supra* note 5, at 85,958. The amended Rule requires the final official statement to provide a "description of the undertakings to be provided . . . and of any instance in the previous five years in which each person specified . . . failed to comply, in all material respects, with any previous undertakings in a written contract or agreement." *Id.* at 85,980.

215. See *supra* note 209 for the amended definition of "final official statement."

216. See Release No. 34,961, *supra* note 5, at 85,953 (commenting that a broad range of market participants "supported the goal of improved secondary market disclosure . . . , but emphasized that flexibility is necessary, given the diversity that exists in the municipal securities market").

217. *Id.*

218. *Id.* at 85,956.

should ensure that existing final official statement preparation practices continue at current or improved levels.<sup>219</sup>

ii. Pooled financings must employ an objective criteria approach

The fact that Rule 15c2-12 now requires bond pools to set objective criteria for disclosing obligated persons' financial information and operating data also illustrates the flexibility of the definition of "final official statement."<sup>220</sup> Because members of the pool may change over time, it is difficult to determine which parties constitute "obligated persons" in a pooled financing.<sup>221</sup> To address this concern, the Commission adopted an objective criteria approach that requires bond pools to describe the standards they will apply—in preparing the official statement and on an ongoing basis—to determine whether information regarding a certain obligated person should be provided.<sup>222</sup> The new rule further requires that the official statement specify when and how the objective criteria will be applied.<sup>223</sup> If an obligated person no longer satisfies the objective criteria, the amended Rule relieves this party of its disclosure obligations.<sup>224</sup>

iii. The amended Rule permits the final official statement to reference other publicly available information

The amended definition of "final official statement" provides that the document or set of documents comprising the final official statement may explicitly include the parties' "financial information" and "operating data"<sup>225</sup> and/or incorporate by reference documents already prepared and previously made "publicly available."<sup>226</sup> If the official statement cross references publicly available financial information and operating data, it is considered to include all of the incorporated information and documents for purposes of determining

---

219. See *id.* ("The fact that the amendments rely on the final official statement to set the standard for ongoing disclosure should not serve as an incentive for issuers to reduce existing disclosure practices in the preparation of the final official statement.").

220. *Id.* at 85,961. The amended Rule also allows, but does not require, non-pooled issues to use the objective criteria approach. *Id.*

221. *Id.*

222. *Id.* The SEC recommends that the objective criteria include the percentage of payment support provided by each member of the pool. *Id.* The Commission did not, however, provide any express recommendations as to the proper scope of the objective criteria. *Id.* at n.81.

223. *Id.*

224. *Id.* at 85,961.

225. For an explanation of financial information and operating data as defined under amended Rule 15c2-12, see *infra* part V.B.iv.b.

226. Release No. 34,961, *supra* note 5, at 85,957. For a definition of "publicly available" information under the amended Rule, see *supra* note 215.

the scope of the parties' secondary market disclosure obligation.<sup>227</sup> Cross referencing creates two benefits.<sup>228</sup> First, cross referencing will allow the parties to prepare official statements that are clear and concise, yet comprehensive.<sup>229</sup> Second, it will help issuers compile information about parties who are material to the offering, but over whom the issuer does not have control.<sup>230</sup> This second benefit arises because information about nonissuer controlled parties will theoretically be available from existing national repositories or, if the party is a reporting company under the 1934 Act, from the SEC.<sup>231</sup>

- iv. The amended Rule requires the undertaking to disclose past instances of non-compliance

Finally, the amended Rule requires that the final official statement disclose whether any party providing annual financial information in connection with the offering failed to comply with any prior undertakings within the past five years.<sup>232</sup> The Commission adopted this provision to give parties an "additional incentive" to comply with their secondary market disclosure obligations and to enable underwriters to better evaluate the reliability of the disclosed information.<sup>233</sup> These requirements also benefit investors in the secondary market because the parties' documents will clearly show what information is to be disclosed, who will disclose it, and whether the parties have complied with previous undertakings.<sup>234</sup>

- b. "Annual financial information" includes both "financial information" and "operating data"

Amended Rule 15c2-12 requires underwriters to determine that at least one of the parties involved in the issue contracts to distribute

---

227. Release No. 34,961, *supra* note 5, at 85,957.

228. *See id.* (discussing the benefits of cross referencing noted by commentators).

229. *Id.*

230. *Id.*

231. *Id.*

232. *Id.* at 85,958.

233. *Id.* With respect to an underwriter's obligation under the federal antifraud provisions, the Commission clarified that the amended Rule does not prevent underwriters from participating in

an Offering of municipal securities if an issuer or obligated person has failed to comply with previous undertakings to provide secondary market disclosure. However, if a failure to comply with such previous undertakings has not been remedied as of the start of the Offering, or if the party has a history of persistent and material breaches, it is doubtful whether a Participating Underwriter could form a reasonable basis for relying on the accuracy of the issuer's or obligated person's ongoing disclosure representations.

*Id.*

234. *Id.*

“annual financial information”<sup>235</sup> in the final official statement and on a continuing basis.<sup>236</sup> Annual financial information consists of financial information and operating data that is released once a year and contained in the final official statement.<sup>237</sup> For example, if the final official statement contains financial information or operating data regarding an obligated person, annual financial information with respect to that party would consist of the same type of financial information or operating data.<sup>238</sup> This definition promotes the amended Rule’s policy of flexibility by setting a minimum standard for ongoing disclosure, which permits the parties to define that standard for each offering.<sup>239</sup>

i. “Financial information” consists of qualitative information

The amended Rule defines “annual financial information” in terms of “financial information” and “operating data.” The Commission commented that financial information may include unaudited financial statements, and may occasionally require something less than full financial statements.<sup>240</sup> Nonetheless, the undertaking must include annual audited financial statements when the party otherwise

---

235. Under the amended Rule, “annual financial information” is defined as financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in a document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information repository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

*Id.* at 85,980.

236. This provision only applies to the annual financial information indicated in the undertaking. *Id.* at 85,963. For example, the amended Rule’s dissemination provisions do not cover financial information and reports prepared by the issuer or obligated persons that are not related to the issue. *Id.*

237. *Id.* at 85,962.

238. *Id.* at 85,963.

239. *Id.*

240. *Id.* at 85,964. In qualifying this statement, the SEC explained:

While it is anticipated that full financial statements will be provided for entities with ongoing revenues and operating expenses, it is possible that in the case of dedicated revenue streams and certain types of structure financings, other types of special purpose financial statements, project operating statements or reports may be used to reflect the financial position of the credit source for the financing.

*Id.*

prepares them, such as where the party is required under state or federal law to prepare audited financial statements.<sup>241</sup> The undertaking must also specify the accounting principals used to prepare the financial information.<sup>242</sup> Finally, the undertaking must indicate when and to whom the annual financial information for the preceding fiscal year will be provided.<sup>243</sup> Beyond these three requirements, the amended Rule does not specify the form or content of financial information other than by reference to the final official statement.<sup>244</sup> The SEC did indicate, however, that sequential final official statements prepared by frequent issuers may meet the definition of "financial information."<sup>245</sup> Like the initial disclosure provided in the final official statement, periodic financial information may incorporate publicly available information by reference.<sup>246</sup>

ii. "Operating data" comprises quantitative information

A second category of annual financial information is "operating data."<sup>247</sup> The amended Rule requires operating data to enable investors and other market participants to objectively evaluate the issue.<sup>248</sup> As with financial information, the type of operating data presented in the final official statement determines the type of annual operating data to be disclosed on a periodic basis.<sup>249</sup> When compiling the operating data for the final official statement, the SEC recommends that the parties consider current industry practices.<sup>250</sup>

2. *The Amended Rule Imposes A Duty On Underwriters and Dealers To Ensure That Issuers and Obligated Persons Provide Notices Of Material Events*

In addition to requiring issuers and obligated persons to provide annual financial information, the amended Rule requires these parties

---

241. *Id.* The undertaking must specify whether the party will include audited financial statements in its annual financial information. *Id.*

242. *Id.* Consistent preparation of financial information enables market participants to evaluate the party's financial condition and to perform year-to-year comparisons. *Id.*

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.*

247. *Id.* The SEC explained that the word "data" connotes quantitative information. *Id.*

248. *Id.*

249. *Id.*

250. *Id.* at 85,964-65. For example, in a conduit health care financing, under current industry practice, the hospital typically provides information in an appendix. *Id.* at 85,965. This information generally includes a description of the hospital, its administration and management, economic base and service area, its capital plan, and operating statistics, such as bed utilization, admissions, patient days, and payor utilization. *Id.*

to release timely material event notices to each national repository or to the Municipal Securities Rulemaking Board and to the appropriate state information repository, if one exists.<sup>251</sup> If the issuers and obligated persons do not contract to release material event notices, the amended Rule prohibits underwriters from purchasing or selling those securities in the primary market.<sup>252</sup> Likewise, the amended Rule prohibits dealers from recommending transactions in the secondary market unless they establish procedures to receive prompt notice of any event disclosed pursuant to the above requirements.<sup>253</sup> Moreover, the dealer must ensure that any individual responsible for recommending municipal securities receives these material event notices.<sup>254</sup> Unlike the amended Rule, Rule 15c2-12 as originally enacted did not explicitly impose any such duty on dealers.<sup>255</sup> Consequently, dealers will face greater responsibilities under the amended Rule to gather information about the securities that they recommend and will likely incur higher compliance costs, particularly those dealers who do not currently subscribe to an information reporting service.<sup>256</sup>

By placing restrictions on underwriters and dealers, the material event notice provisions of the amended Rule compel issuers and obligated persons to release notices of material events to the secondary market.<sup>257</sup> To assist issuers and obligated persons in determining

---

251. *Id.*

252. *Id.* Amended Rule 15c2-12 precludes underwriters from purchasing or selling municipal securities unless the issue includes an undertaking to provide

[i]n a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information repository, if any, notice of any of the following events with respect to the securities being offered . . . if material . . . .

*Id.* at 85,979. For a list of events normally deemed "material," see *infra* text accompanying note 262.

253. Release No. 34,961, *supra* note 5, at 85,979. Under the amended Rule, a dealer is prohibited from "recommend[ing] the purchase or sale of a municipal security unless . . . [it] has procedures in place that provide reasonable assurance that it will receive prompt notice of" any of the eleven listed events or notice of failure to provide annual financial information in accordance with the undertaking. *Id.*

254. *Id.* at 85,969. The amended Rule does not require that dealers directly review the issuer's disclosure documents before recommending an issue. *Id.* In contrast, the amendments as proposed would have prohibited dealers from recommending municipal securities without first examining the issuer's ongoing disclosure documents. *Id.* Commentators expressed concerns, however, that such a requirement would unduly burden dealers and adversely affect liquidity in the secondary municipal market. *Id.*

255. For a discussion of the requirements of Rule 15c2-12 as enacted in 1989, see *supra* part III.C.2.

256. Release No. 34,961, *supra* note 5, at 85,957. With respect to those dealers that already subscribe to electronic reporting services, the SEC emphasized that such dealers must verify that the services to which they subscribe receive notices for issues that the dealer recommends. *Id.*

257. *Id.* at 85,965.

which events must be reported, the amended Rule lists eleven events that normally affect the securities' terms and the credit sources that support their repayment.<sup>258</sup> The amended Rule does not, however, require the issuer or obligated person to provide notice of such events unless the event is "material."<sup>259</sup> Therefore, an issuer or obligated person must provide notice if (1) a listed event occurs and (2) the event is "material."<sup>260</sup> The following eleven events potentially require notice under the amended Rule:

(1) principal and interest payment delinquencies; (2) nonpayment related defaults; (3) unscheduled draws on debt service reserves reflecting financial difficulties; (4) unscheduled draws on credit enhancements reflecting financial difficulties; (5) substitution of credit or liquidity providers or their failure to perform; (6) adverse tax opinions or events affecting the tax-exempt status of the security; (7) modifications to rights of security holders; (8) bond calls; (9) defeasances; (10) release, substitution, or sale of property securing repayment of the securities; (11) ratings changes.<sup>261</sup>

The amended Rule leaves the determination of whether the information undertaking should require notification of events other than those listed above.<sup>262</sup> The party responsible for the disclosure undertaking must promise to give timely notice of a failure of any other party to disclose annual financial information as required by the final official statement.<sup>263</sup> The Rule does not specify what constitutes "timely" notice.<sup>264</sup>

### 3. *Information Repositories Play An Integral Role In Effectuating the Amended Rule*

Information repositories assume paramount importance in the collection and dissemination of secondary market information under the amended Rule.<sup>265</sup> The purpose of these information repositories is to

---

258. *Id.* at 85,965-66.

259. *Id.* at 85,965.

260. *Id.*

261. *Id.* at 85,979.

262. *Id.* at 85,966.

263. *Id.* Paragraph (b)(5)(i)(D) of the amended Rule requires the party to release [i]n a timely manner, to each nationally recognized municipal securities information repository or the Municipal Securities Rulemaking Board, and to the appropriate state information repository, if any, notice of a failure of any person . . . [specified in the final official statement] to provide required annual financial information, on or before the date specified in the written agreement or contract.

*Id.* at 85,979.

264. *Id.* 85,967. The SEC remarked only that timeliness depends on "the time needed to discover the occurrence of the event, assess its materiality, and prepare and disseminate the notice." *Id.*

265. *Id.* at 85,970.

collect and disseminate the required annual financial information and notices of material events.<sup>266</sup> In particular, the Rule requires dissemination to Nationally Recognized Municipal Information Repositories (NRMSIRs) and State Information Repositories (SIDs).<sup>267</sup>

a. Nationally Recognized Municipal Securities Information Repositories

As of the writing of this Article, three private information vendors qualified as NRMSIRs.<sup>268</sup> NRMSIRs basically function as disseminators of final official statements for underwriters.<sup>269</sup> Information repositories seeking NRMSIR status must apply to the SEC for recognition.<sup>270</sup> The amended Rule does not expressly define "NRMSIR."<sup>271</sup> Instead, the SEC set forth six factors that it will consider in determining whether a particular information repository qualifies as a NRMSIR.<sup>272</sup> These factors include, but are not limited to, whether the repository

(1) is national in scope; (2) maintains current, accurate, information about municipal offerings in the form of official statements, and annual financial information, notices of material events, and notices of a failure to provide annual financial information undertaken to be provided in accordance with Rule 15c2-12; (3) has effective retrieval and dissemination systems; (4) places no limits on the parties from which it will accept official statements and annual financial information, notice of material events, and notices of a failure to provide annual financial information to be provided in accordance with Rule 15c2-12; (5) provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and (6) charges reasonable fees.<sup>273</sup>

---

266. *Id.*

267. *Id.* at 85,970-73. The amended Rule requires parties to file annual financial information with each NRMSIR and the SID located in the issuer's state. *Id.* at 85,978-79. The Rule further requires parties to file notices of material events and notices of failures by a party to provide annual financial information with each NRMSIR or the MSRB and with the appropriate SID. *Id.* at 85,979.

268. *Id.* at 85,970. These NRMSIRs gathered and disseminated issuer final official statements pursuant to former Rule 15c2-12 and, although not required under the provisions of the old Rule, disseminated other current issuer information to the primary and secondary municipal markets. *Id.* When it adopted the 1994 amendments to Rule 15c2-12, the SEC determined that these NRMSIRs should reapply for recognition in light of the amendments. *Id.* at 85,971.

269. *Id.* at 85,970.

270. *Id.* at 85,971.

271. *See id.* (setting forth the factors to consider in determining whether an entity is a NRMSIR).

272. *Id.*

273. *Id.* With respect to the accuracy requirement, the SEC merely requires NRMSIRs to accurately report the information provided to them; NRMSIRs are not responsible for verifying whether the information itself is correct. *Id.* at 85,971 n.155. Under the reasonable fee require-



## b. State Information Depositories

The amended Rule relies on SIDs to disseminate annual financial information and material event notices.<sup>274</sup> SIDs are "depositories operated or designated by the state that receive[ ] information from all issuers within the state, and make[ ] this information available promptly to the public on a contemporaneous basis."<sup>275</sup> Therefore, a SID may be a public or private entity.<sup>276</sup> For example, New York already operates a state-based dissemination system.<sup>277</sup> In addition, numerous third party state-based information collectors currently exist.<sup>278</sup>

## 4. Exemptions to Amended Rule 15c2-12

Beyond adding the dissemination requirements for annual financial information and material event notices discussed above, the amended Rule adopts three new exemptions that exclude certain issuers from all the provisions of the amended Rule.<sup>279</sup> The first exemption applies to small issuers.<sup>280</sup> The second allows dealers to recommend secondary market transactions in securities that lack an undertaking to provide annual financial information or notices of material events if the issue falls under one of the existing exemptions for limited placements, short-term securities, or securities with demand features.<sup>281</sup> The amended Rule contains a third new exemption that excludes short-term securities from the annual financial information requirement.<sup>282</sup>

---

ment, NRMSIRs are permitted to charge reasonable fees for disseminating information, however, they are precluded from charging issuers for accepting information under the amended Rule. *Id.*

274. *Id.* at 85,972.

275. *Id.* (footnote omitted).

276. *Id.* at n.167.

277. *Id.* at 85,972. The New York State Comptroller commented that states may perform "an appropriate and important function . . . in the secondary market disclosure process." *Id.* (footnote omitted).

278. *Id.*

279. *Id.* at 85,974-77. In addition, the three exemptions under the old Rule remain applicable. *Id.* at 85,977. For further discussion of these exemptions, see *supra* part III.C.2. The SEC also amended the transactional exemption to clarify that it possesses exemptive authority over both underwriters who participate in primary offerings and brokers, dealers and municipal securities dealers who recommend municipal securities in the secondary market. Release No. 34,961, *supra* note 5, at 85,977.

280. *Id.* at 85,974-75.

281. *Id.*

282. *Id.* at 85,977.

a. The small issuer exemption

To qualify for the small issuer exemption, each obligated person, including the issuer, must fulfill three requirements.<sup>283</sup> First, no obligated person may have more than \$10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities.<sup>284</sup> However, this \$10,000,000 aggregate principal amount does not include any securities excluded from Rule 15c2-12 under the old exemptions for limited placements, short-term securities, or securities with demand features.<sup>285</sup> Second, the issuer or other obligated person must provide a limited disclosure undertaking.<sup>286</sup> Third, the final official statement must include the name, address, and telephone number of the persons from whom the disclosure provided pursuant to the limited undertaking can be obtained.<sup>287</sup>

b. Exemption from the annual financial information requirement for short-term securities

The amended Rule also includes an exemption from the annual financial information requirement for short-term securities.<sup>288</sup> Under this exemption, short-term securities include offerings with a maturity of eighteen months or less.<sup>289</sup> Nonetheless, the provisions of amended Rule 15c2-12 that require dissemination of notices of material events

---

283. *Id.* at 85,974.

284. *Id.* Paragraph (d)(2)(i) of the amended Rule provides that underwriters may recommend transactions in municipal securities if "[n]o obligated person will be an obligated person with respect to more than \$10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities and excluding municipal securities that were offered in a transaction" excluded from Rule 15c2-12 under the existing exemptions for limited placements, short-term securities, or securities with demand features. *Id.* at 85,980.

285. *Id.* at 85,974.

286. *Id.* This limited disclosure undertaking requires the party to either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide: [u]pon request to any person or at least annually to the appropriate state information depository, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and [i]n a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of [material] events . . .

*Id.* at 85,980.

287. *Id.*

288. *Id.*

289. *Id.* In contrast, the old exemption for short-term securities included offerings with a maturity of nine months or less. See *supra* notes 161-67 and accompanying text (discussing the exemptions to Rule 15c2-12 as enacted in 1989).

still apply to these short-term offerings, unless the offering is exempt under a separate exemption from Rule 15c2-12.<sup>290</sup>

- c. Exemptions from recommendation prohibition where dealers do not institute procedures to receive notices of material events

The third new exemption allows dealers to recommend securities with an aggregate principal amount of less than \$1,000,000, securities qualifying for the existing exemptions for limited placements, short-term securities, or securities with demand features, and securities within the exemption for small issuers, notwithstanding that the dealer does not institute procedures to receive timely notice of material events regarding these securities.<sup>291</sup> Under this exemption, a dealer is permitted to recommend primary and secondary market transactions in securities for which there is no undertaking, provided that such securities were exempt from Rule 15c2-12 at the time of their original issuance.<sup>292</sup>

## V. ANALYSIS OF AMENDED RULE 15c2-12

This Section analyzes amended Rule 15c-12. The Analysis begins by questioning the SEC's authority to enforce the Rule's provisions. Second, the Analysis argues that, assuming the SEC does possess such enforcement authority, the amended Rule fails to provide market participants with any meaningful disclosure guidance beyond that already supplied by the MSRB Rules and the GFOA *Guidelines*.

### A. *The SEC's Authority to Enforce the Amended Rule Is Questionable*

As discussed above, the Exchange Act does not explicitly authorize the SEC to directly govern municipal issuer disclosure.<sup>293</sup> Moreover, the Tower Amendment expressly prohibits the SEC and the MSRB from directly or indirectly requiring municipal securities issuers to file any application, report, or document with the SEC or the MSRB before their securities are sold.<sup>294</sup> The Tower Amendment further prohibits the MSRB from requiring issuers to furnish investors or the MSRB with any "report, document, or information" not generally

---

290. Release No. 34,961, *supra* note 5, at 85,980.

291. *Id.* at 85,977.

292. *Id.* at 85,977 n.205.

293. Staff Report, *supra* note 6, at 20.

294. *Id.* at 19-20. For a discussion of the Tower Amendment, see *supra* part III.D.1.

available from a source other than the issuer.<sup>295</sup> Despite the SEC's apparent lack of authority to control municipal issue disclosure, Rule 15c2-12 was adopted in 1989;<sup>296</sup> in promulgating amended Rule 15c2-12, the SEC in 1994 sought to expand its influence over municipal issuer disclosure practices by restricting the ability of municipal underwriters and dealers to recommend transactions in municipal securities for which the issuer has failed to provide the disclosure required by the rule.<sup>297</sup>

The limits placed on municipal underwriters and dealers clearly affect municipal issuer disclosure by indirectly forcing municipal issuers to comply with the amended Rule's provisions to market their securities.<sup>298</sup> Such regulation of municipal issuers appears to be in immediate conflict with the language and intent of the Tower Amendment. First, the provisions of the amended Rule that require underwriters who recommend transactions in the primary market to ensure that issuers and other obligors enter into an undertaking to provide ongoing secondary market disclosure indirectly regulates issuers. The amended Rule essentially forces issuers to contract to provide ongoing disclosure, because if they do not, underwriters are prohibited from selling their securities.

Similar to the registration and reporting requirements of the federal securities laws, from which municipal securities are explicitly exempt, the new Rule necessarily compels issuers to determine what information to disclose pursuant to the undertaking, to enter into the undertaking, and to disseminate the selected information in their final official statement and on an annual basis to SEC-regulated state and national information reporting agencies for as long as the issue remains outstanding. Therefore, the amended Rule allows the SEC to regulate municipal issuer disclosure just as effectively as if the SEC had promulgated a rule that directly required municipal issuers to register their securities prior to sale, which is what the Tower Amendment expressly prohibits, and to provide ongoing disclosure.

Second, the provisions of the amended Rule that relate to material event notices indirectly regulate municipal issuer disclosure. The amended Rule prohibits underwriters from recommending transac-

---

295. Staff Report, *supra* note 6, at 20. Congress enacted this section to clarify that it did not intend the Tower Amendment to subject states, cities, counties or any other municipal authorities to any of the MSRB's disclosure requirements. *Id.*

296. MARC I. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* § 13.03 (1994).

297. *Id.*

298. For a discussion of the additional obligations imposed on underwriters by the amended Rule, see *supra* part IV.B.

tions in issues where no undertaking to provide notices of material events exists, and requires dealers to institute procedures to receive material event notices as a condition to recommending secondary market transactions. Therefore, like the Rule's ongoing disclosure provisions, its material event notice provisions indirectly compel issuers to disseminate information to SEC-controlled state and national repositories, or to the MSRB, to enable underwriters and dealers to execute secondary market transactions in their securities. These requirements appear to fly in the face of the Tower Amendment's prohibition on the MSRB from requiring municipal issuers to furnish investors or the MSRB with any information not generally available from a source other than the issuer.

Despite the amended Rule's apparent conflict with the language of the Tower Amendment, evidence exists that the SEC's Division of Market Regulation at least believes the Commission possesses the authority to regulate municipal issuer disclosure in this manner. Specifically, the Staff Report recommended that the SEC amend Rule 15c2-12 "to prohibit municipal securities dealers from recommending outstanding municipal securities unless the municipal issuer makes available ongoing information regarding the financial condition of the issuer of the type required in initial offerings."<sup>299</sup> The Report further recommended that the SEC use its interpretive authority to provide issuers with disclosure guidance under the federal antifraud provisions.<sup>300</sup>

Notwithstanding the Staff Report's endorsement of the Commission's authority to promulgate and enforce the amended Rule, by passing the Tower Amendment, Congress expressly proscribed the SEC's power to regulate issuer disclosure indirectly through municipal securities dealers. As discussed above, by requiring municipal issuers to distribute prior to the securities' sale copies of the official statement to any national repository or the MSRB, and by prohibiting underwriters and dealers from entering into municipal transactions where the issuer's disclosure documents fall short of the amended Rule's standards, amended Rule 15c2-12 indirectly regulates municipal issuers.<sup>301</sup> Thus, the amended Rule arguably grants the SEC enforcement authority beyond that which Congress intended.

---

299. Staff Report, *supra* note 6, at 52.

300. *Id.* The SEC followed the Report's recommendation by publishing the 1994 interpretive release. See Release No. 33,741 *supra* note 23 (setting forth specific guidelines for issuers regarding disclosure under the federal antifraud provisions); see also Release No. 26,985 *supra* note 23 (providing additional recommendations to municipal market participants regarding their obligations under the federal antifraud provisions).

301. See *supra* part IV.B (discussing the provisions of amended Rule 15c2-12).

*B. The Amended Rule Fails to Adequately Address the Problems in the Municipal Market*

Assuming that the SEC has the authority to promulgate and enforce the amended Rule, on close examination, it is apparent that the Rule will not result in any marked improvement in municipal market disclosure. Congress carved out broad exemptions for municipal securities from the registration and reporting requirements of the federal securities laws; the federal antifraud provisions and state Blue Sky laws continue to provide the only mandatory means by which municipal issuer disclosure is governed.<sup>302</sup> Under these standards, disclosure remains inadequate in the primary and secondary municipal markets.<sup>303</sup>

*1. The Primary Market*

The principal difficulty with primary market disclosure is a lack of uniformity. The municipal regulatory structure depends on market pressures and voluntary compliance to promote issuer disclosure. Predictably, the official statements of larger issuers meet or exceed the GFOA *Guidelines*, while small issuers' official statements generally involve brief documents that barely comply with the minimal standards under the federal antifraud provisions.<sup>304</sup> Because the amended Rule follows the SEC's traditional approach to municipal disclosure, which relies on market discipline and compliance with the federal antifraud provisions, the SEC's mere enactment of the amended Rule will not effectively remedy the lack of uniformity in primary market disclosure.

Under the market approach, the quality of municipal issuer disclosure documents primarily depends on the voluntary undertaking of individual issuers to prepare complete documents and the competence of the advice that issuers receive from underwriters, financial advisors, and counsel. Although the amended Rule makes the issuer's undertaking to provide disclosure a prerequisite to the purchase or sale of its securities, the Rule fails to provide meaningful guidance to market participants regarding the precise form and content of disclosure documents. The policies behind the amended Rule are flexibility and respect for the diversity of the municipal market. Rather than promulgating discrete guidelines for municipal issuer disclosure docu-

---

302. For a discussion of municipal market regulation prior to the enactment of amended Rule 15c2-12, see *supra* part III.

303. See *supra* part IV.A (discussing the problems with municipal market disclosure practices).

304. Staff Report, *supra* note 6, at 38.

ments, the amended Rule provides minimal standards and encourages issuers to look to SEC interpretive releases and the GFOA *Guidelines* for advice when preparing their official statements. However, in many cases, the amended Rule's minimum requirements fall short of the recommendations in the GFOA *Guidelines*.<sup>305</sup>

For example, although the amended Rule requires preparation of financial statements in conformance with generally accepted accounting principals, it requires audited financial statements only where state or local law otherwise compels the issuer to prepare them.<sup>306</sup> In contrast, the GFOA *Guidelines* recommend financial statements prepared in accordance with generally accepted auditing standards. Furthermore, unlike the GFOA *Guidelines*, the amended Rule does not specifically describe what information issuers should include in the final official statement. The amended Rule simply requires issuers to indicate what annual financial information will be provided and when and to whom it will be provided.<sup>307</sup>

In addition, the GFOA *Guidelines* recommend that issuers' official statements include specific financial information regarding the use of conduit borrowing and credit enhancements. While the amended Rule "obligated person" concept encompasses conduit borrowers, it explicitly excludes providers of credit enhancements.<sup>308</sup> Moreover, because the SEC does not include a specified percentage of payment in the definition of obligated person, the amended Rule imparts the issuer and other obligors with the sole discretion to determine which obligors are material to the offering when the final official statement is prepared.

In conclusion, absent definite and clearly enforceable disclosure standards, market participants with greater resources, such as large, frequent issuers, will continue to prepare more comprehensive disclosure documents that meet or exceed the GFOA *Guidelines*, and smaller, less frequent issuers with inadequate time and money to spend on compliance will persist in providing minimal disclosure. Consequently, the amended Rule does not provide an effective solution to the lack of uniformity in disclosure practices that plagues the primary municipal market.

---

305. See *supra* notes 135-40 for a discussion of the GFOA *Guidelines*.

306. Release No. 34,961, *supra* note 5, at 85,964.

307. *Id.*

308. See *supra* note 197 (defining "obligated person" under the Rule).

## 2. *The Secondary Market*

Unlike the problems in the primary market, which originate from inconsistent information, the principal deficiencies in the secondary market revolve around inadequate information. In particular, because the Exchange Act's periodic reporting requirements do not apply to issuers of municipal securities, trading in the secondary municipal market depends on issuers' voluntary dissemination of periodic financial statements and disclosure provided in official statements when issuers return to the market with new offerings. This lack of continuing disclosure adversely affects individual investors' ability to make intelligent, informed investment decisions and the efficiency of the increasingly complex municipal market.<sup>309</sup>

The amended Rule primarily focuses on improving disclosure in the secondary market. By prohibiting dealers from recommending secondary market transactions in municipal securities without an undertaking by the parties to provide annual financial information and material event notices, the amended Rule will effectively increase the volume of secondary market disclosure. Furthermore, the amended Rule requires secondary market disclosure to be timely. The increased availability of timely information will allow individual investors to make better-informed purchase decisions and will likely decrease their reliance on financial intermediaries' investment advice. Therefore, the amended Rule provides an apparent solution to some of the basic problems that result from inadequate information in the secondary municipal market.

Under the amended Rule, the final official statement sets the standard for ongoing disclosure.<sup>310</sup> This means that an issuer's disclosure to the secondary market under the amended Rule will be no more complete than that to the primary market. Thus, the same problems exist with reference to the form and content of ongoing disclosure documents as discussed above in the context of initial disclosures to the primary market. The amended Rule relies on electronic information repositories to disseminate this secondary market information. It does not, however, require the repositories to verify the accuracy of the information that they receive.<sup>311</sup> For that reason, the amended Rule does not sufficiently address the problem of inaccurate information in the secondary municipal market, which inhibits market effi-

---

309. For further discussion of the problems with secondary market disclosure, see *supra* part IV.A.2.

310. See *supra* part V.B.1.a (discussing the impact of the final official statement on secondary market disclosure under the amended Rule).

311. Release No. 34,961, *supra* note 5, at 85,971.



ciency and accurate pricing of municipal securities. Moreover, while the amended Rule directs issuers to disseminate their financial information to all national repositories or to the MSRB and to the repository in their state, if one exists, it fails to clearly delineate the relationship between these information reporting agencies. Nor does it provide for any type of indexing system by which to link the reporting systems.

#### CONCLUSION

Although it appears that the SEC lacks the authority to enforce the amended Rule under a literal reading of the Tower Amendment, the history of Rule 15c2-12 and the Staff Report's recommendations suggest that the SEC's authority to regulate issuer disclosure under Exchange Act Section 15(c) is not in dispute. Assuming that the SEC has not overstepped its statutory authority, the amended Rule will not effectively improve upon current municipal issuer disclosure practices, which already rely on market pressures to determine the proper level of disclosure. The diversity of the municipal market necessitates flexible disclosure standards; however, too much flexibility results in a lack of meaningful guidance to market participants. Without definite and clearly enforceable disclosure standards, the dichotomy in primary market disclosure will remain. Furthermore, notwithstanding that the amended Rule will increase the volume of information disclosed to the secondary market, problems still exist regarding the accuracy of such information. Greater disclosure will not necessarily result in greater market efficiency absent some means of verification and a central indexing system designed to help market participants locate information regarding a particular issuer. Given that the amended Rule appears merely to reiterate the SEC's current practice of relying on market forces to dictate the proper level of municipal disclosure, the Rule is unnecessary and confusing—particularly since the SEC arguably has overstepped its authority by attempting to indirectly regulate municipal issuer disclosure.

*Christine A. Scheel*